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No. 10191

United States Circuit Court of Appeals

For the Ninth Circuit.

Vol I

2311

N. N. S. MATCOVICH,

Appellant.

vs.

RICHARD NICKELL, as Collector of Internal Revenue for the First District of California,

Appellee.

Transcript of Record

Upon Appeal from the District Court of the United States for the Northern District of California, Southern Division

ROTARY COLORPRINT, 590 FOLSOM ST., SAN FRANCISCO

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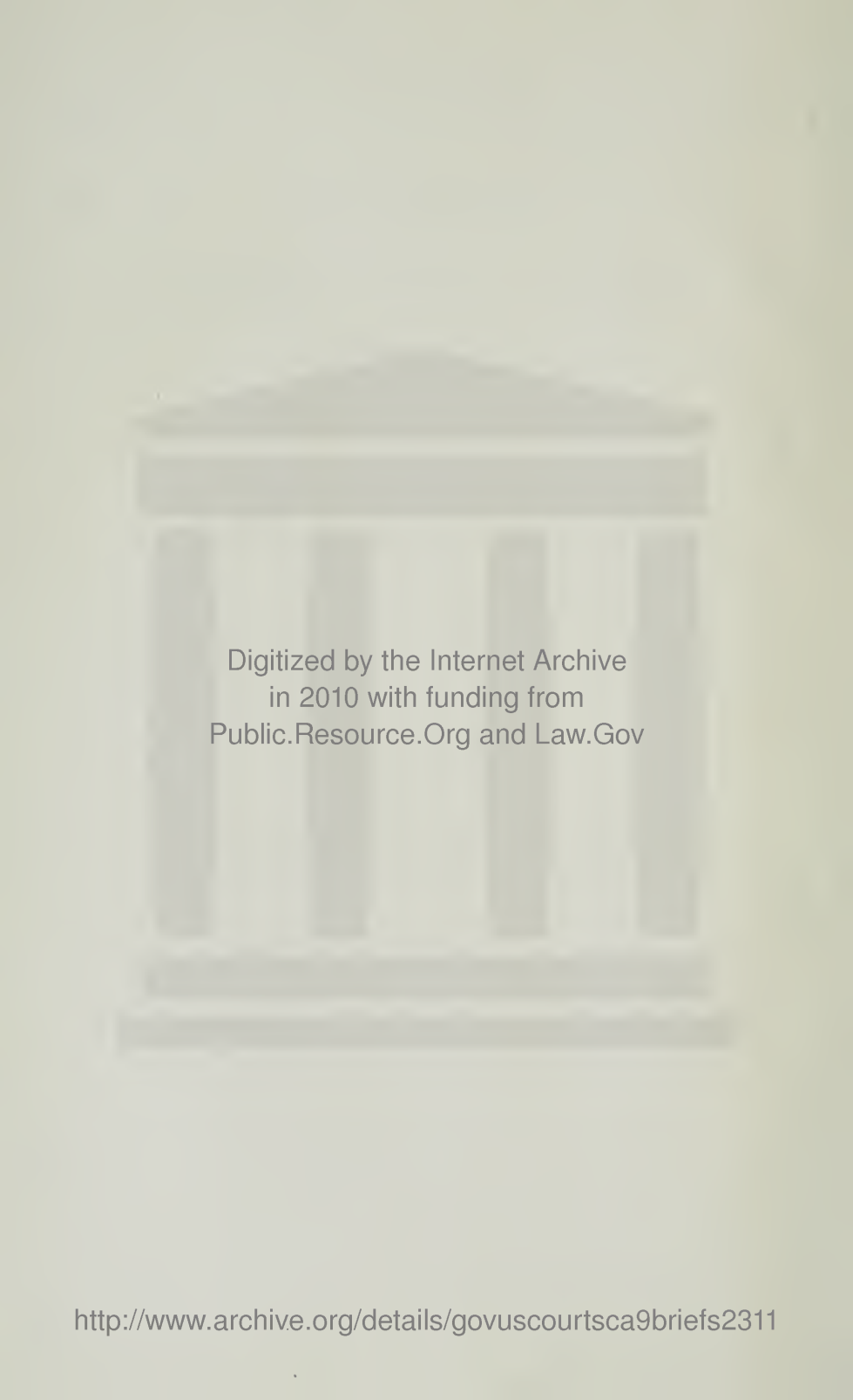

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

NAMES AND ADDRESSES OF ATTORNEYS

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Sacramento, California
Attorney for Plaintiff and Appellant,

HON. FRANK J. HENNESSY,
United States Attorney,

ESTHER B. PHILLIPS,
Assistant United States Attorney,
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7th and Mission Streets
San Francisco, California
Attorneys for Defendant and Appellee.

In the District Court of the United States, for the Northern District of California, Southern Division.

Civil Action File No. 22203-R

N. N. S. MATCOVICH,

Plaintiff,

-vs-

RICHARD NICKELL, as Collector of Internal Revenue for the First District of California,

Defendant.

BILL OF COMPLAINT

Plaintiff complains of defendant and for cause of action alleges:

I.

That defendant is the duly appointed Collector of Internal Revenue for the First District of California, having and maintaining his office in the City and County of San Francisco.

II.

This action arises under Federal Unemployment Tax Act, formerly Title IX of the Social Security Act, now Sub-chapter C of Chapter IX of the Internal Revenue Code, and the Federal Insurance Contributions Act, formerly Title VIII of the Social Security Act, now Sub-chapter A of Chapter IX of the Internal Revenue Code.

III.

That during the period 1938, 1939, and 1940 plain-

tiff conducted a dance hall in the City of Sacramento, State of California. [1*]

IV.

That during said period in conducting said dance hall plaintiff licensed certain ladies to use said premises for the purpose of dancing.

V.

That the defendant has demanded from plaintiff the sum of $3,204.65, together with a five per cent penalty and interest on said sum at the rate of seven and one-half per cent per annum from the 7th day of March, 1941 to the 15th day of June, 1942, as a tax under said Federal Insurance Contributions Act, and the sum of $5,066.79 for contributions under and pursuant to said Federal Unemployment Tax Act, together with the sum of $253.54 penalty and interest on said sum of $5,066.79 at the rate of seven and one-half per cent per annum from the 21st day of July, 1941, to date; that said defendant bases his demand for said respective sums on the claim that said ladies were employees of said plaintiff.

VI.

That said ladies are not employees of plaintiff, and were never at any time during said period, employees of plaintiff; that said ladies are not employees of plaintiff and do not come within the terms of said Federal Insurance Contributions Act or said Federal Unemployment Tax Act, in that said Acts and Tax assessed thereunder are based upon the

*Page numbering appearing at foot of page of original certified Transcript of Record.

relation of employer and employee; that the relationship which existed between plaintiff and said ladies during said period was one of licensor and licensee, and that said ladies during said period of time were independant contractors. And in this connection, plaintiff alleges that each of said ladies prior to dancing in plaintiff's place of business entered into a license agreement, a copy of which is in the following words and figures:

> "This is to certify that . . . is hereby granted the privilege of engaging in dancing with patrons of the undersigned at 416-18 K Street, Sacramento, California, in consideration of the payment to the undersigned of a portion of the money earned by her as mutually agreed upon.
>
> In granting this privilege, it is the intent hereof that licensee shall not become an employee of the undersigned and that she shall not become subject to the control of the undersigned.
>
> Licensee agrees to abide by all regulations established [2] by the undersigned in the operation of his business.
>
> Dated_____ 19_____
>
> RIO BALL ROOM
> 416-K Street,
> Sacramento, California
>
> By
>
> Accepted:
>
> By "

That no other agreement of any kind was ever entered into between said plaintiff and said ladies. That said ladies during said period danced in said premises under the license issued to them by plaintiff and by and under no other agreement or arrangement.

VII.

That the said Tax Assessments are erroneous, unlawful and void, because, as hereinabove pointed out, the relationship of employer and employee did not exist between plaintiff and said ladies during said period, and therefore the action by the defendant is attempting to levy a tax in this instance is arbitrary and an unlawful exercise of administrative authority.

VIII.

That on or about the 19th day of May, 1942, plaintiff filed claim for abatement of said respective taxes and assessments, basing his claim for abatement on the ground that there was no tax, assessment or contributions due because the relation of employer and employee did not exist; that said claim for abatement was denied. That said defendant is preparing to and will unless restrained and enjoined by this Court seize and distrain plaintiff's property under the pretended authority of the said Tax Assessments. That said tax is erroneous, unlawful and void.

IX.

That plaintiff has no plain, speedy or adequate remedy at law for the reason that his action to determine the legality of the said tax assessment may

not be brought except upon payment of the said tax assessment and suit to recover it back. That plaintiff is unable to pay the said sum of $8,271.45 without working serious and irreparable damage to his property and business, [3] which could not subsequently be remedied by the recovery of this tax by suit after payment. That if defendant *siezes* and distrains the property of plaintiff and sells the same plaintiff's entire business will be lost and destroyed, which will result in irreparable damage to him.

X.

That during all of said period plaintiff claims for the reasons herein stated that there was no tax due and therefore did not pay any tax, nor did he make any deductions from the moneys received by said ladies from persons dancing with them as required by said Acts, if the relation of employer and employee existed, relying upon the following facts and circumstances:

All of said ladies desiring to dance in his said premises entered into the license agreement, a copy of which is hereinbefore set out, prior to their dancing in said premises. That pursuant to said agreement said ladies so desiring to dance therein were licensees only, and not employees. That more than sixty ladies annually have executed and operated under said license agreement during the years 1939, 1940 and 1941.

That plaintiff is informed and verily believes and therefore alleges that no claim of any kind was ever filed by any of said ladies under and pursuant to

the provisions of said State Employment Act or Social Security Act, until during the year 1939 when one Mary C. Mosier filed an application for compensation under the State Unemployment Act based upon services alleged to have been performed from October, 1938, to February, 1939. That plaintiff resisted said application. Said application was denied by the Adjustment Unit of the Division of Unemployment Insurance of said State of California on the ground that the employer and employee relation did not exist. That thereupon said Mary C. Mosier took an appeal to the Appeals Tribunal of the California Employment Commission; that the Appeal Officer of said Commission, on the 8th day of October, 1940, affirmed the determination of the Adjustment Unit of the Division of Unemployment Insurance, which held that Mary C. Mosier was not an employee.

That said California Employment Commission, on the 13th day of January, 1939, filed an action in the Superior Court of the State of California, in and [4] for the County of Sacramento, against plaintiff herein, for the purpose of recovering contributions under and pursuant to the said Unemployment Act based upon taxable wages alleged to have been earned by said ladies during the years 1936, 1937, and the first quarter of 1938, on the theory that the employer and employee relation existed between plaintiff and said ladies. That Honorable Peter J. Shields, before whom said action was tried, on the 24th day of January, 1940, held that the said Cali-

fornia Employment Commission was not entitled to recover because the relation of employer and employee between said plaintiff herein and said ladies did not exist.

That during the years 1939, 1940 and 1941 no proceedings were taken to collect the tax assessment for the years 1939, 1940 and 1941.

That by reason of the foregoing circumstances, it would be unjust and inequitable to compel plaintiff to pay said taxes and assessments until such time as it is determined that said taxes and assessments are justly due from plaintiff.

Wherefore, plaintiff prays judgment against said defendant that there is no tax or assessment due under either of said Acts as claimed by defendant, and that defendant, his deputies, agents, representatives and employees, be enjoined and restrained from assessing, levying or collecting any of said taxes, and from doing any acts of any nature calculated to enforce or satisfy the above mentioned tax or assessments until such time that the above entitled Court shall have determined whether said taxes or assessments have been properly levied or assessed, and for such further relief as may be just and proper in the circumstances, and for costs of suit.

Dated: June 9th, 1942.

R. H. SCHWAB

Attorney for Plaintiff [5]

(Duly verified.)

[Endorsed]: Filed Jun. 9 1942 [6]

[Title of District Court and Cause.]

ORDER TO SHOW CAUSE

The plaintiff, N. N. S. Matcovich, having filed herein his verified Bill of Complaint, praying that the above named defendant, his agents, representatives and servants, and each of them, be restrained and enjoined from assessing, levying or collecting a certain tax assessment against said plaintiff, which said tax assessment is fully described in said Complaint, and from doing any acts of any nature calculated to enforce or satisfy the above mentioned tax assessment during the pendency of this action;

It Is Therefore Ordered that said defendant, Richard Nickell, as Collector of Internal Revenue of the First District of California, appear before this Court in the Courtroom, located in the Post Office Building on 7th and Mission Streets, in the City and County of San Francisco, State of California, at 10:00 o'clock on the 22nd day of June, 1942, then and there to show cause, if any he has, why he should not be restrained and enjoined [7] during the pendency of this action from doing or causing to be done, any act or thing designed to enforce, collect or satisfy a certain tax assessment made by defendant Richard Nickell, as Collector of Internal Revenue, against plaintiff as an employer, etc., said assessment being in the amount of $8,271.45.

It Is Further Ordered that a copy of the Bill of Complaint herein and of this Order, be served on each of the Defendants herein.

Dated: June 9th, 1942.

MICHAEL J. ROCHE
Judge of the United States
District Court.

Return of Service of Writ (attached to Copy).

[Endorsed]: Filed Jun. 9 1942 [8]

[Title of District Court and Cause.]

MOTION TO DISMISS

Now Comes the defendant above named and moves the Court for its order dismissing the complaint filed herein on the following ground:

That suit to enjoin or restrain the assessment or collection of taxes is expressly forbidden by the provisions of Section 3653 of the U. S. Internal Revenue Code, which reads:

> "(a) Tax.—Except as provided in Sections 272 (a), 871 (a) and 1012 (a), no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court.
>
> "(b) Liability of Transferee or Fiduciary,—No Suit shall be maintained in any court for the purpose of restraining the assessment or collection of (1) the amount of the liability, at law or in equity, of a transferee of property of a taxpayer in respect of any income, war-profits, excess-profits, or state tax. (2) the amount of the liability, at law or in equity, of a transferee

of property of a donor in respect of any gift tax, or (3) the amount of the liability of a fiduciary under section 3467 of the Revised Statutes (U.S.C. Title 31, Sec. 192) in respect of any such tax." [9]

That the complaint fails to show legal reasons for the court to disregard the provisions of Section 3653, above quoted.

FRANK J. HENNESSY,
United States Attorney,
ESTHER B. PHILLIPS,
Assistant United States
Attorney.

(Receipt of service)

[Endorsed]: Filed June 22, 1942 [10]

[Title of District Court and Cause.]

ORDER GRANTING DEFENDANT'S MOTION TO DISMISS AND DENYING INJUNCTIVE RELIEF TO PLAINTIFF.

The order to show cause why the Plaintiff's prayer for injunctive relief should not be granted, coming on for hearing June 22, 1942, the plaintiff appearing by his attorney, R. H. Schwab, and the defendant appearing by his attorney Frank J. Hennessy, United States Attorney for the Northern District of California, represented by Esther B. Phillips, Assistant United States Attorney, and the defendant having moved for dismissal of the

complaint and the prayer of the plaintiff for injunctive relief, and the defendant's prayer for dismissal of the complaint having been orally heard, and the Court having considered the authorities and argument of counsel, it is Hereby Ordered, Adjudged and Decreed that the defendant's motion to dismiss the complaint be granted and the plaintiff's prayer for injunctive relief be and the same is hereby denied.

Dated: June 22, 1942.

MICHAEL J. ROCHE
United States District Judge.

[Endorsed]: Filed Jun 22, 1942. [11]

In the Southern Division of the United States District Court for the Northern District of California.

No. 22203-R

N. N. S. MATCOVICH,

Plaintiff,

vs.

RICHARD NICKELL, as Collector of Internal Revenue for the First District of California,

Defendant.

JUDGMENT OF DISMISSAL

The Court having heretofore, on the 22nd day of June, 1942, granted defendant's motion to dis-

miss and having this day ordered that a judgment of dismissal be entered herein;

Now, therefore, by virtue of the law and by reason of the premises aforesaid, it is considered by the Court that the plaintiff take nothing by this action and that the defendant go hereof without *day.*

Judgment entered this 30th day of June, 1942.

WALTER B. MALING
Clerk

[Endorsed]: Filed Jun. 30, 1942. [12]

[Title of District Court and Cause.]

NOTICE OF APPEAL

To the Honorable Michael J. Roche, Judge of the Above Entitled Court:

The above named plaintiff, feeling himself aggrieved by the judgment of dismissal and the order discharging the order to show cause made and entered in the above-entitled cause on the 3rd day of June 1942, does hereby appeal from said judgment of dismissal and order discharging said order to show cause, Circuit Court of Appeals for the Ninth District, for the reason specified in the statement of plaintiff's points on appeal which are filed herewith.

And your petitioner further shows that he has filed with the Clerk of the above entitled court a bond in the sum of Two Hundred and Fifty

($250.00) Dollars for costs on appeal conditioned as required by law.

Dated: July 3, 1942

R. H. SCHWAB
Attorney for Plaintiff

[Endorsed]: Filed Jul. 3 1942. [13]

[Title of District Court and Cause.]

BOND ON APPEAL

Know All Men by These Presents:

That we, N. N. S. Matcovich, as principal, and Hartford Accident and Indemnity Company, an incorporated surety company authorized to do business in the State of California, as surety, acknowledge ourselves to be jointly indebted to Richard Nickell, appellee in the above case, in the sum of Two Hundred and Fifty ($250.00) Dollars, conditioned, that, whereas, on the 30th day of June, 1942, in the District Court of the United States, for the Northern District of California, Southern Division, in a suit pending in that court, wherein N. N. S. Matcovich, was plaintiff, numbered on the docket thereof as Civil Action #22203-R, a decree was rendered against the said N. N. S. Matcovich, and the said N. N. S. Matcovich having appealed to the Circuit Court of Appeals of the United States, for the Ninth Circuit, at San Francisco, California, and filed copy of said notice of appeal in the office

of the clerk of the court to reverse said decree;

Now, if the said N. N. S. Matcovich shall prosecute his appeal to execute and answer all costs if he fails to make his plea good, then the above obligation to be void, else to remain in full force and virtue. [14]

It Is Further Stipulated as a part of the foregoing bond, that in case of the breach of any condition thereof, the above named District Court may, upon notice to the surety above named, of not less than ten days, proceed summarily in said suit to ascertain the amount which said surety is bound to pay on account of such breach, and render judgment therefor against said surety and award execution therefor, not in excess of the foregoing sum.

Executed, this 3rd day of July, 1942.

N. N. S. MATCOVICH
Principal
By
His Attorney.
HARTFORD ACCIDENT & INDEMNITY CO.
By ROBT. F. CULPEPPER
Attorney-in-Fact

(Duly verified.)

[Endorsed]: Filed Jul. 3, 1942. [15]

[Title of District Court and Cause.]

STATEMENT OF PLAINTIFF'S AND APPELLANT'S POINTS ON APPEAL

Comes now the plaintiff and appellant, N. N. S. Matcovich, and presents herewith his statement of the points on appeal on which he intends to rely on the appeal in the above entitled action:

1. The Court erred in granting the motion of dismissal of the Bill of Complaint in view of the admitted allegations in the complaint to the effect that the persons claimed by defendant to be employees of plaintiff were not and never were, during the years 1938, 1939 and 1940, for which reason no tax could be levied under the Federal Contributions Act or the Federal Unemployment Tax Act.

2. The Court erred in dismissing said bill of complaint in view of the admitted fact before the Court as alle*d*ged in the complaint that the relation which existed between the plaintiff and the persons whom defendant claimed were employees, were in fact licensees and independent contractors.

3. That the Court erred in dismissing said bill of complaint in that the contract set forth in said complaint definitely fixed the relations between plaintiff and said alle*d*ged employees as that of licensor and licensee. [16]

4. That the Court erred in dismissing said complaint in that a contract set forth in said complaint which grants to said alleged employees the privilege of dancing in plaintiff's place of business and that

for said privilege, said alleged employees pay therefore. That as further stated and alleged in said contract that it is the intention of said parties to said contract that said alleged employees should not become an employee of the plaintiff and further that alleged employees should not become subject to the control of said plaintiff.

5. That the court erred in dismissing said complaint in that it is alleged in said complaint that the tax assessments referred to therein were erroneous, unlawful and void. Because the relationship of employer and employee did not exist and, therefore, the action between defendant in an attempt to levy a tax was an arbitrary and unlawful exercise of the administrative authority of said defendant.

6. That the Court erred in dismissing said complaint and discharging said order to show cause in that it is alleged in said complaint that plaintiff had no plain, speedy or adequate remedy at law for the reason that plaintiff's business would be totally destroyed before an action to recover back the taxes if paid, could be brought and concluded.

7. That the Court erred in dismissing said complaint and discharging said order to show cause that to allege in said complaint that plaintiff is unable to pay sum of $8,271.45 without working serious and irreparable damage to his property and business.

8. That the Court erred in dismissing said complaint and discharging said order to show cause in that it is alleged in said complaint that if defend-

ant siezes and distrains the property of plaintiff and sells the same, plaintiff's entire business will be lost and destroyed which will result in irreparable damage to him.

9. That the court erred in dismissing said complaint and discharging said order to show cause in that neither the defendant nor his predecessor, during the years 1939, 1940 or 1941 took any proceedings to collect said tax for said years and permitted said tax to accumulate to such an amount that plaintiff is now unable to pay the same, and that all during said period, said plaintiff relied upon the decesion of the Superior Court for the State [17] of California and for the County of Sacramento, Judge Peter J. Shields presiding, that the relation of employer and employee did not exist between plaintiff and said alleged employees. That plaintiff also relied upon the decision of the Department of Employment of the State of California, holding that relationship of employer and employee did not exist between plaintiff and said alleged employees.

10. That Court erred in dismissing the Complaint and discharging the order to show cause in that the bill of complaint, which for the purposes of the order to show cause must be taken as true, stated among other matters that plaintiff had no plain, speedy or adequate remedy at law, for the reason that his action to determine the legality of the tax involved in said action may not be brought except upon the payment of said tax and suit re-

covered back. That plaintiff is unable to pay the tax, namely, $8,271.45, without working serious and irreparable damage to his property and business, which could not subsequently be remedied by the recovery of this tax by suit after payment. That if defendant s*ie*zes and distrains the property of plaintiff, and sells the same, plaintiff's entire business will be lost and destroyed, which will result in irreparable damage to him.

11. That it would be inequitable now to permit defendant to collect said taxes before the determination that the relationship of employer and employee existed during said period.

Wherefore, plaintiff prays that the said judgment of dismissal and said order discharging said order to show cause be reversed and that proper decrees be entered on record herein *for* prayed for in his bill of complaint.

Dated: July 3, 1942.

R. H. SCHWAB
Attorney for Plaintiff

[Endorsed]: Filed Jul 3 1942 [18]

[Title of District Court and Cause.]

PLAINTIFF AND APPELLANT'S DESIGNATION OF CONTENTS OF RECORD OF APPEAL.

Comes now the Plaintiff and Appellant, N. N. S. Matcovich, and does hereby designate the following

as the contents of his record to be included on Appeal:

I.

The Bill of Complaint.

II.

Order to Show Cause.

III.

Motion to Dismiss.

IV.

Order Discharging Order to Show Cause.

V.

Judgment of dismissal.

VI.

Notice of Appeal. [19]

VII.

Statement of Plaintiff's points on appeal.

VIII.

The designation of the contents of the Record ot Appeal.

IX.

Bond of Appeal.

Dated: July 6th, 1942.

R. H. SCHWAB

Attorney for Plaintiff

(Receipt of Service)

[Endorsed]: Filed Jul. 7 1942. [20]

District Court of the United States
Northern District of California

CERTIFICATE OF CLERK TO TRANSCRIPT OF RECORD ON APPEAL

I, Walter B. Maling, Clerk of the District Court of the United States, for the Northern District of California, do hereby certify that the foregoing pages, numbered from 1 to 20, inclusive, contain a full, true, and correct transcript of the records and proceedings in the case of N. N. S. Matcovich, Plaintiff v. Richard Nickell, etc. Defendant. No. 22203-R., as the same now remain on file and of record in my office.

I further certify that the cost of preparing and certifying the foregoing transcript of record on appeal is the sum of Three dollars and five cents ($3.05) and that the said amount has been paid to me by the Attorney for the appellant herein.

In Witness Whereof, I have hereunto set my hand and affixed the seal of said District Court at San Francisco, California, this 29th day of July A. D. 1942.

[Seal] WALTER B. MALING
Clerk
WM. J. CROSBY
Deputy Clerk [21]

[Endorsed]: No. 10191. United States Circuit Court of Appeals for the Ninth Circuit. N. N. S. Matcovich, Appellant, vs. Richard Nickell, as Collector of Internal Revenue for the First District of California, Appellee. Transcript of Record. Upon Appeal from the District Court of the United States for the Northern District of California, Southern Division.

Filed July 31, 1942.

PAUL P. O'BRIEN,

Clerk of the United States Circuit Court of Appeals for the Ninth Circuit.

In the Circuit Court of Appeals of the United States in and for the Ninth District.

No. 10191

N. N. S. MATCOVICH,

Plaintiff and Appellant,

vs.

RICHARD NICKELL, as Collector of Internal Revenue for the First District of California,

Defendant and Appellee.

NOTICE OF ADOPTION OF POINTS ON APPEAL.

To the Clerk of the Above Entitled Court and to Attorneys for Appellee:

Please Take Notice that Appellant does hereby adopt statement of Plaintiff's and Appellant's

points on appeal appearing in the transcript of record for all purposes on the appeal in the above entitled court.

You Are Further Notified that the Appellant hereby requests that the entire transcript be printed as certified in its entirety.

Dated: August 4, 1942.

R. H. SCHWAB

[Endorsed]: Filed Aug. 5, 1942.

No. 10,191

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

N. N. S. MATCOVICH,

Appellant,

vs.

RICHARD NICKELL, as Collector of Internal Revenue for the First District of California,

Appellee.

APPELLANT'S OPENING BRIEF.

R. H. SCHWAB,
Forum Building, Sacramento, California,
Attorney for Appellant.

PERNAU-WALSH PRINTING CO., SAN FRANCISCO

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No. 10,191

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

N. N. S. MATCOVICH,
Appellant,

vs.

RICHARD NICKELL, as Collector of Internal Revenue for the First District of California,
Appellee.

APPELLANT'S OPENING BRIEF.

STATEMENT SHOWING JURISDICTIONAL FACTS.

This action was brought to restrain the defendant, Collector of Internal Revenue from collecting an alleged tax due under the Federal Insurance Contributions Act and for contributions under Federal Employment Tax Act.

The matter comes before this Court on an appeal from a judgment based upon the granting of a motion to dismiss based upon the ground that complaint fails to show legal reasons for the Court to disregard the provisions of Section 3653 of the Internal Revenue Code and an order denying injunctive relief to plaintiff pursuant to an order to show cause for that purpose.

The main propositions upon which the complaint is based are: That plaintiff is not subject to either of the above referred to acts because the relation of employer and employee did not exist for which reason the alleged contributions were not due or collectible. That plaintiff would be irreparably damaged if the defendant collected the total amount alleged to be due, namely, $8271.45 because plaintiff was unable to pay said sum and that if defendant seized and distrains the property of plaintiff and sells the same, plaintiff's entire business would be lost and destroyed. Plaintiff therefore maintains that if the relation of employer and employee does not exist defendant had no right to enforce collection and since the equitable grounds are present the collector should be restrained notwithstanding the provision of section 3653 United States Internal Revenue Code.

FACTS ALLEGED IN THE COMPLAINT.

The following facts alleged in the complaint for the purposes of this case must be taken as true.

The complaint alleges that during the years 1938, 1939 and 1940 plaintiff conducted a dance hall in the city of Sacramento and that during that period, plaintiff licensed certain ladies to use said premises for the purpose of dancing. That said ladies were not employees of the plaintiff and did not come within the terms of the said Insurance Contributions Act or said Federal Employment Tax Act during said period since the operation of said acts are based upon the relation-

ship of employer and employee. That the only relationship which did exist between the plaintiff and said ladies during said period, was one of licensor and licensee, and that said ladies during said period were independent contractors. It is further alleged that an agreement was entered into between plaintiff with each one of the ladies dancing in the premises of plaintiff which granted each of said ladies the privilege of engaging in dancing with the patrons of plaintiff in his premises in consideration of the payment to him of the portion of the money earned by each of said ladies as mutually agreed upon. It is further stated in said agreement that it was the intent thereof that they should not become employees of plaintiff nor should be subject to his control. It is further alleged in said complaint that there was no other agreement of any kind entered into between plaintiff and said ladies. That said ladies during said period danced under the license issued to them pursuant to said agreement and under no other agreement or arrangement. It is then alleged that said tax assessments were erroneous, unlawful and void because the relation of employer and employee did not exist. And, therefore, the action by the defendant in attempting to levy a tax is an arbitrary and unlawful exercise of administrative authority. That a claim of abatement for said taxes and assessments were denied and that the defendant, unless restrained, will seize and restrain plaintiff's property under said authority of said tax assessment. It is then alleged that plaintiff has no plain, speedy, or adequate remedy at law for the reason that his action to determine the legality of said assessment may not be

brought except upon the payment of said tax assessment and a suit to recover it back. Plaintiff then alleges that he is unable to pay the said sum claimed $8271.45 without working serious and irreparable damage to his property and business which could not subsequently be remedied by the recovery of this tax by suit after payment. That if the defendant seizes and distrains the property of plaintiff and sells the same, plaintiff's entire business will be lost and destroyed which will result in the irreparable damage to him. That plaintiff then alleges that the reason he did not pay said tax during said period of 1939, 1940 and 1941 was because of the following facts and circumstances:

That all ladies desiring to dance in said premises of plaintiff entered into the license agreement under which agreement they were licensees only and not employees. That more than sixty ladies annually executed and operated under said licensed agreement during said period. That no claim of any kind was ever filed by any of said ladies, except during the year 1939 one Mary C. Mosier filed an application for compensation under the State Unemployment Act, which application was finally denied on the theory that she was not an employee. That during that same year the California Employment Commission filed an action in the Superior Court of Sacramento County to recover contributions based upon the alleged taxable wages of said ladies during the years 1936, 1937 and the first quarter of 1938. On the theory that the relation of employer and employee existed, Honorable Peter J. Shields, before whom said action was tried, held that

the commission was not entitled to recover because the relation of employer and employee did not exist. That all during said period, 1939, 1940 and 1941, no proceedings were taken by the defendant to collect any taxes. That it would be unjust and inequitable under those circumstances to compel the plaintiff to pay said taxes and assessments until such time as it be determined that said taxes and assessments are due from plaintiff.

LAW OF THE CASE.

The facts alleged in the complaint as a motion to dismiss must be accepted as true.

The motion to dismiss was based upon the ground that suit to enjoin or restrain the assessment or collection of taxes is expressly forbidden in Section 3653 of the U. S. Internal Revenue Code. The contention of the appellant is that before the tax or assessment can be levied and collected, the basic fact must be presented, namely, that the relation of employer and employee existed. Under those circumstances, if equitable grounds are present, the Court, in the exercise of its equitable jurisdiction will restrain the collection of the tax.

In the case of *Miller v. Standard Nut Margerine,* 284 U. S. 498 at page 509, 52 S. Ct. 26, 76 L. Ed. 422, the Court said:

> "Independently of, and in cases arising prior to, the enactment of the provision which became Rev. Stat. Section 3224, U.S.C. title 26, Section 154, this court in harmony with the rule generally

followed in courts of equity held that a suit will not lie to restrain the collection of a tax upon the sole ground of its illegality. The principal reason is that, as courts are without authority to apportion or equalize taxes or to make assessments, such suits would enable those liable for taxes in some amount to delay payment or possibly to escape their lawful burden and so to interfere with and thwart the collection of revenues for the support of the government. And this court likewise recognizes the rule that, in cases where complainant shows that in addition to the illegality of an exaction in the guise of a tax there exist special and extraordinary circumstances sufficient to bring the case within some acknowledged head of equity jurisprudence, a suit may be maintained to enjoin the collector."

The action of *Midwest Haulers Inc. v. Brady, Acting Collector,* 128 Fed. (2d) 496, decided June 2, 1942, was brought to enjoin the collection of additional taxes assessed against plaintiff under Title VIII and IX of the Social Security Act. It is there claimed that the additional tax was illegal and that the collection of them would cause the irreparable injury and would destroy its business and that it was without an adequate remedy at law. The lower Court granted a motion to dismiss based upon Section 3653 of the Internal Revenue Code. The Court said:

"Appellant concedes that the statute applies to all assessments and collections of Internal Revenue taxes made or attempted to be made under color of office by Internal Revenue officers charged with general jurisdiction over the assessment and col-

lection of such taxes, but it argues that notwithstanding the statute, courts have the power to restrain the assessment or collection of taxes where the remedy of the taxpayer at law to recover a tax illegally assessed or collected, is inadequate, or where there exists extraordinary and exceptional circumstances which bring the case within some settled field of equitable jurisdiction or where the exaction sought to be restrained is not within the definition of a tax. The question thus simmers down to whether appellant has stated a case not covered by the Statute."

The Court then, in its opinion, reviews the allegations of the complaint which showed the tax to be illegal and also that the enforced collection would result in a total loss of business. The Court then said:

"(2-5) Section 3653 of the Internal Revenue Code is not an absolute bar to every action to restrain the collection of an illegal tax. Hill v. Wallace, 259 U. S. 44, 62, 42 S. Ct. 453, 66 L. Ed. 822; Miller v. Standard Nut Margarine Co., 284 U. S. 498, 509, 52 S. Ct. 269, 76 L. Ed. 422; Dodge v. Osborn, 240 U. S. 118, 122, 36 S. Ct. 275, 60 L. Ed. 557. The genesis of this statute is found in Section 19 of the Act of March 2, 1867, ch. 169, 14 Stat. 475. Originally, it was an amendment of the Internal Revenue Act of July 13, 1866, ch. 184, 12 Stat. 152. The Act of which it was made a part expressly provided for a remedy at law by suit to recover taxes erroneously or illegally assessed or collected. In its present language it appeared in the Revised Statutes independently of the Revenue Act as R. S. 3224. Its original and

present setting require that it be construed in pari materia with other parts of the Internal Revenue Act which give to a taxpayer the unqualified right of recovery of all that has been illegally exacted from him under the guise of a tax. Snyder v. Marks, 109 U. S. 189, 3 S. Ct. 157, 27 L. Ed. 901. When it is made to appear that the rights and property of an alleged taxpayer will be utterly destroyed if he is compelled to pay a tax that is not in fact his obligation and the pursuit of his remedy by suit for the recovery will not adequately restore to him that which he has lost, a court of equity may take jurisdiction to grant relief in advance of payment notwithstanding the prohibition in Section 3653. The complaint in the case at bar, the allegations of which are admitted by the motion to dismiss, alleges facts which if true, show that the taxes sought to be collected by the appellee from appellant probably are not in fact due and the allegations further show that appellant's principal assets are intangibles composed of contracts with the owners of carrier's equipment and Universal and certificates of convenience and necessity for the use of the public highways of the states in which appellant is authorized to conduct its business. The allegations further show that these assets could not be sold at forced sale at any price and that a sale of the other assets of appellant will incidentally destroy its intangibles. It thus appears that the collection of the taxes alleged to be due by distrain and sale would destroy property of appellant, the the value of which it could in no way recover through the processes provided under the Internal Revenue Law.

In our opinion the case at bar comes within the exceptions to Section 3653 of the Internal Revenue Code stated by the Supreme Court in Hill v. Wallace, supra; Dodge v. Brady, supra; Allen v. Regents, 304 U. S. 439, 449, 58 S. Ct. 980, 82 L. Ed. 1448; Raymond v. Chicago Union Traction Co., 207 U. S. 20, 39, 28 S. Ct. 7, 52 L. Ed. 78, 12 Ann. Cas. 757.

Judgment reversed and cause remanded for further proceedings consistent with this opinion."

Under the above authorities, we submit the complaint does state a cause of action for the relief requested, for which reason the judgment should be reversed.

Dated, Sacramento, California,
September 18, 1942.

Respectfully submitted,
R. H. SCHWAB,
Attorney for Appellant.

No. 10,191

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

N. N. S. MATCOVICH,

Appellant,

vs.

RICHARD NICKELL, as Collector of Internal Revenue for the First District of California,

Appellee.

On Appeal from the District Court of the United States for the Northern District of California.

BRIEF FOR APPELLEE.

SAMUEL O. CLARK, JR.,
Assistant Attorney General,
SEWALL KEY,
J. LOUIS MONARCH,
MILLS KITCHIN,
Special Assistants to the Attorney General,
FRANK J. HENNESSY,
United States Attorney,
ESTHER B. PHILLIPS,
Assistant United States Attorney,
Attorneys for Appellee.

PERNAU-WALSH PRINTING CO., SAN FRANCISCO

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Codes and Statutes

No. 10,191

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

N. N. S. MATCOVICH,

Appellant,

vs.

RICHARD NICKELL, as Collector of Internal Revenue for the First District of California,

Appellee.

On Appeal from the District Court of the United States for the Northern District of California.

BRIEF FOR APPELLEE.

OPINION BELOW.

The court below did not write an opinion nor enter any findings of fact or conclusions of law, but granted the Collector's motion to dismiss the bill of complaint and denied taxpayer's prayer for injunctive relief.

JURISDICTION.

This is an appeal from the order of the District Court dated June 22, 1942 (R. 11-12), granting the Collector's motion to dismiss taxpayer's bill of com-

plaint and denying him the relief prayed for. The complaint prayed for an injunction to restrain the collection of certain federal unemployment taxes. The jurisdiction of the District Court was apparently invoked under Section 24 of the Judicial Code, as amended. Appeal was thereupon taken from the District Court's order to this Court under date of July 3, 1942 (R. 13), under the provisions of Section 128(a) of the Judicial Code, as amended.

QUESTION PRESENTED.

Whether this suit to restrain the collection of taxes was prohibited by Section 3653 of the United States Internal Revenue Code.

STATUTE INVOLVED.

Internal Revenue Code:

> SEC. 3653. PROHIBITION OF SUITS TO RESTRAIN ASSESSMENT OR COLLECTION.
>
> (a) *Tax.*—Except as provided in sections 272(a), 871(a) and 1012(a), no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court.
>
> (b) *Liability of Transferee or Fiduciary.*—No suit shall be maintained in any court for the purpose of restraining the assessment or collection of (1) the amount of the liability, at law or in equity, of a transferee of property of a taxpayer

in respect of any income, war-profits, excess-profits, or estate tax, (2) the amount of the liability, at law or in equity, of a transferee of property of a donor in respect of any gift tax, or (3) the amount of the liability of a fiduciary under section 3467 of the Revised States (U. S. C., Title 31, §192) in respect of any such tax. (U. S. C. 1940 ed., Title 26, Sec. 3653.)

STATEMENT.

In the court below the bill of complaint substantially and briefly alleged as follows: During the years 1938, 1939 and 1940 taxpayer conducted a dance hall in the city of Sacramento, California, and licensed to dance therein certain ladies who were not his employees (R. 2-3), but who danced at his premises under a licensing agreement which provided that the licensee did not become an employee of the undersigned, but agreed to abide by all regulations established by him in the operation of his business (R. 4); that no other agreement of any kind was ever entered into between appellant and those ladies and that the tax assessments were based on appellee's erroneous holding that the dancing ladies were employees of appellant and that the relationship of independent contractors did not exist between the ladies and the taxpayer; that taxpayer did not come within the terms of the Federal Insurance Contributions Act or the Federal Unemployment Act, and that the taxes assessed thereunder were erroneous, unlawful and void (R. 3-5); that on or about May 19, 1942, taxpayer filed a claim for abate-

ment of these taxes and assessments, but that the abatement claim was denied and that the Collector was preparing to distrain and sell his property unless restrained and enjoined by the court (R. 5); that taxpayer had no plain, speedy, or adequate remedy at law for the reason that his action to determine the legality of the tax assessments may not be brought except upon payment of the tax and suit to recover it back, which he was unable to do and that therefore the payment of the taxes in the amount of $8,271.45 would work serious and irreparable damage to his property and business, which could not subsequently be remedied by the recovery of this tax by suit after payment; and that if the Collector seized and distrained upon the property of taxpayer, his entire business would have been lost and destroyed (R. 5-6); that, therefore, for the reasons stated, there was no tax due from taxpayer and therefore he did not pay any tax nor did he make any deductions from the moneys received by the ladies as required by the acts if the relationship of employer and employee existed because all of the ladies dancing in his premises entered into a license agreement prior to their dancing and that pursuant to such agreement the ladies who danced therein were licensees only and not employees (R. 6); and that taxpayer was informed and believed that no claim of any kind was ever filed by any of the ladies under and pursuant to the State Employment Act or Social Security Act until during the year 1939 when one of the ladies filed such an application for compensation under the State Employment Act based upon services alleged to have been

performed from October, 1938, to February, 1939, but that taxpayer resisted such application and that application was denied by the Adjustment Unit of the Division of Unemployment Insurance of the State of California on the ground that the employer and employee relationship did not exist; that thereupon the lady took an appeal from such decision and that the appellate body affirmed the ruling that the relationship of employer and employee did not exist between taxpayer and the lady; and that thereafter the California Employment Commission on January 13, 1939, filed an action in the Superior Court of California for the County of Sacramento against taxpayer for the purpose of recovering contributions under and pursuant to the Unemployment Act based upon the taxable wages alleged to have been determined by the dancing ladies during the years 1936, 1937, and the first quarter of 1938, on the theory that the relationship of employer and employee existed between taxpayer and the ladies; that thereafter the Honorable Peter J. Shields, before whom such action was tried on January 24, 1940, held that the California Employment Commission was not entitled to recover from taxpayer because the relation of employer and employee between taxpayer and the ladies did not exist. (R. 6-7.)

Whereupon, taxpayer prayed that judgment be entered against the Collector that there was no tax or assessment due under either of the acts as claimed by the Collector, and that the Collector, his deputies, agents and employees be enjoined and restrained from assessing, levying, or collecting any of the taxes, and

from doing any other thing designed to enforce or satisfy the tax or assessment thereof until such time that the court should have determined whether the taxes or assessment had been properly levied and assessed and for such further relief as may be just and proper under the circumstances, and for his costs. (R. 8.)

The court below issued an order to show cause to the Collector (R. 9), who thereupon, through the United States Attorney for the Northern District of California, interposed a motion to dismiss on the ground that Section 3653 of the United States Internal Revenue Code denies the court jurisdiction to entertain the bill of injunction, and that the complaint failed to show reasons why the provisions of this section should be disregarded. On the same date that such a motion was filed, the court heard arguments thereon and granted the Collector's motion to dismiss the bill of complaint and denied the relief prayed for therein.

SUMMARY OF ARGUMENT.

The prohibition of Section 3653, *supra,* is absolute and clearly denies the equity jurisdiction contended for here. The bill discloses that the dancing ladies were procured by taxpayer and signed an agreement with him to abide by all regulations established by him in the operation of his business. It is shown that the validity of the tax depends upon the resolution of a question of law and that the tax assessment is predicated upon an administrative determination made by

a duly constituted officer in the regular performance of his official duties. In such a situation the statute requires that the tax be paid before a resort can be had to the courts.

Moreover, there is no showing that equitable relief is necessary in this case to prevent great, immediate and irreparable injury to the taxpayer or his property.

The exceptional cases in which jurisdiction has been sustained despite the prohibition of the statute are not applicable here. In those cases it has appeared on the face of the bill that the imposition sought to be collected was a penalty instead of a tax or that there was no legal basis for the tax.

ARGUMENT.

THE PROPOSED ACTION OF THE ADMINISTRATIVE OFFICER HAS A PROPER BASIS AND IS NOT ARBITRARY. MOREOVER, THERE IS NO SHOWING THAT EQUITABLE RELIEF IS NECESSARY TO AVOID IRREPARABLE INJURY. IN THIS SITUATION THE DISTRICT COURT WAS WITHOUT JURISDICTION TO ENJOIN THE COLLECTION.

The provisions of Section 3653 of the Internal Revenue Code were first enacted into law in Section 10 of the Act of March 2, 1867, c. 169, 14 Stat. 471, 475, which was an amendment of the Internal Revenue Act of July 13, 1866, c. 184, 14 Stat. 98, 152. Such section was a part of the revenue act which set up a system of corrective justice to adjudicate tax controversies between the citizen and his Government. Such a system included, and still includes, protest and hearing on tax controversies prior to payment and then appeal

to the courts for final adjudication when the decisions of the administrative department are not agreeable to the taxpayer. The enactment of the law that no suit for the purpose of restraining the assessment or collection of any tax should be maintained in any court was an enactment into law of the long-established rule prevailing in the courts of this Country and in England. *Mooers v. Smedley,* 6 Johns. Ch. (N.Y.) 27 (1823). For seventy-five years this section of the law prohibiting injunctions restraining the collection of taxes has been held inviolate by the United States Supreme, appellate, and district courts.[1]

The bill of complaint shows on its face that taxpayer operated a dance hall and procured a number of ladies to dance with the male patrons of the hall; that the ladies signed an agreement to abide by all regulations established by taxpayer in the operation

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[1] *Graham v. duPont,* 262 U. S. 234; *Bailey v. George,* 259 U. S. 16; *Dodge v. Osborn,* 240 U. S. 118; *Snyder v. Marks,* 109 U. S. 189; *Cheatham v. United States,* 92 U. S. 85; *State Railroad Tax Cases,* 92 U. S. 575; *Gouge v. Hart,* 250 Fed. 802 (W.D. Va.); *Page v. Polk,* 281 Fed. 74 (C.C.A. 1st); *Seaman v. Bowers,* 297 Fed. 371 (C.C.A. 2d); *Cadwalader v. Sturgess,* 297 Fed. 73 (C.C. A. 3d); *Bashara v. Hopkins,* 295 Fed. 319 (C.C.A. 5th); *Sigman v. Reinecke,* 297 Fed. 1005 (C.C.A. 7th); *Hernandez v. M'Ghee,* 294 Fed. 460 (C.C.A. 8th); *Waldron v. Poe,* 1 F. 2d 932 (W.D. Wash.); *Union Fishermen's Co-op. Packing Co. v. Huntley,* 285 Fed. 671 (Ore.); *Witherbee v. Durey,* 296 Fed. 576 (N.D.N.Y.); *Reinecke v. Peacock,* 3 F. 2d 583 (C.C.A. 7th); *Corbus v. Alaska Treadwell Gold-Min. Co.,* 99 Fed. 334 (Alaska), affirmed, 187 U. S. 455; *Straus v. Abrast Realty Co.,* 200 Fed. 327 (E.D.N.Y.); *City of Seattle v. Poe,* 4 F. 2d 276 (W.D. Wash.); *Emaus Silk Co. v. McCaughn,* 6 F. 2d 660 (E.D. Pa.); *Joseph Garneau Co. v. Bowers,* 8 F. 2d 378 (S.D.N.Y.); *McDowell v. Heiner,* 9 F. 2d 120 (W.D.Pa.), affirmed, 15 F. 2d 1015 (C.C.A. 3d), certiorari denied, 273 U. S. 759; *Reinecke v. O. D. Jennings & Co.,* 16 F. 2d 927 (C.C.A. 4th); *Broadway Blending Corp. v. Sugden,* 2 F. Supp. 837 (W.D.N.Y.); *Nan v. Rasmusson,* 1 F. Supp. 446 (Mont.).

of his business; and that there is a controversy between the taxpayer and the Government with respect to whether or not the ladies are employees of the taxpayer. Thus it appears that the validity of the tax depends upon the resolution of a question of law and that the tax assessment is predicated upon an administrative determination made by a duly constituted officer in the regular performance of his duties. In such a situation, we submit that the jurisdiction of the courts to decide the controversy is postponed until after the tax is paid.

In *Snyder v. Marks,* 109 U. S. 189, 192-193, the statutory prohibition against injunction suits was construed to mean that the courts could not interfere with the Collector when he sought to collect "that which is in a condition to be collected as a tax, and is claimed by the proper public officers to be a tax, although on the other side it is alleged to have been erroneously or illegally assessed."

Accordingly, it is our position that a proceeding seeking to enjoin the collection of Federal taxes must stand or fall upon the sufficiency of the averments in the bill of complaint of the existence of such exceptional and extraordinary circumstances as will demonstrate that the proposed action of the administrative officers has no proper basis and is arbitrary. In addition, it must appear that, without equitable relief, the complainant will suffer great, immediate, and irreparable injury to its property.

In the few exceptional cases which have permitted injunctions it has appeared *on the face of the bill* that

the imposition sought to be collected was a penalty instead of a tax, or that the tax was not due. In addition there existed in conjunction therewith a combination of peculiar, unusual and extraordinary facts and circumstances which would deprive plaintiff of his property and make inadequate the results of a suit for the recovery of the taxes complained of. Thus, in *Miller v. Nut Margarine Co.,* 284 U. S. 498, the Court said (p. 510): "A valid oleomargarine tax could by no legal possibility have been assessed against respondent * * *." The Court further found that the combination of unusual facts and circumstances present there (none of which are even remotely akin to those alleged here) justified an exception to the restrictions of the statute and considered the merits of the case prior to payment. This is the leading exception to the prohibition of Section 3633. *Hill v. Wallace,* 259 U. S. 44, was a stockholder's suit and has been classed with the penalty cases. *Graham v. duPont,* 262 U. S. 234, 235, 237-238. The Court held that due to the nation-wide effect which would result from the collection of the tax and penalties and the multiplicity of suits involving each single trade in the grain market, the prohibition of the statute was inapplicable. In *Dodge v. Brady,* 240 U. S. 122, the court below considered the bill for injunction on the merits and dismissed it. When the appeal reached the Supreme Court, that Court held that while the trial court erred in assuming jurisdiction by reason of the provisions of the statute, it would be a waste of time to send the case back since the constitutional question involved had just been adversely decided against the taxpayer

by the Court at that term, and, hence, affirmed the dismissal below. In *Allen v. Regents,* 304 U. S. 590, jurisdiction was sustained because the threatened collection was not a tax but a penalty and the regents had no remedy at law to test the validity of the statute requiring them to collect taxes from the patrons of their athletic contests. In *Midwest Haulers v. Brady,* 128 F. 2d 496 (C. C. A. 6th), the court found that the taxes "probably are not in fact due" and that payment of the tax and a suit for the recovery thereof appeared plainly inadequate as such procedure would have resulted in the utter destruction of the taxpayer's business since it was unable to put up the money, and a sale of its assets (which were largely in the form of contracts, franchises, etc.) to pay its tax would have destroyed it. While we believe the case was erroneously decided, the findings mentioned distinguished it from the instant case.

In each decision which constituted an exception from the prohibition of the statute the peculiar, unusual and extraordinary facts and circumstances pleaded made it plainly appear that the remedy at law was not adequate and that if invoked the destruction or irreparable injury of taxpayer's business would have resulted. But here no such situation exists and this taxpayer has demonstrated in another suit for the recovery of social security taxes that the remedy at law is adequate. He was the plaintiff in *N. N. S. Matcovich v. Anglim* (N. D. Calif.), decided July 11, 1942, motion for rehearing pending, for the recovery of social security taxes for the year 1937, identical in

character with the taxes, the collection of which he seeks to restrain here. There, like here, he contended that the relationship between the ladies who danced at his hall and himself was that of independent contractors and not employee and employer. Thus, the question there in the suit for refund on its merits was identical with the question involving the merits here. The court, through Judge Martin I. Welsh, ruled against him on the merits in the refund suit and held that the relationship of employee and employer existed. This demonstration of a full and adequate remedy at law being available to taxpayer ought to end his case.

The prohibitions of the section involved apply to social security taxes. *Allen v. Shelton,* 96 F. 2d 102 (C.C.A. 5th), certiorari denied, 305 U.S. 630; *Beeland Wholesale Co. v. Davis,* 88 F. 2d 447 (C.C.A. 5th), certiorari denied, 300 U. S. 680; *Alpha Portland Cement Co. v. Davis,* 88 F. 2d 449, certiorari denied, 300 U.S. 681. Hardship on the taxpayer is not sufficient ground for enjoining the collection. *Concentrate Mfg. Corp. v. Higgins,* 90 F. 2d 439 (C.C.A. 2d), certiorari denied, 302 U.S. 714. Alleged avoidance of a multiplicity of suits was not a sufficient ground for restraining the collection of the tax in *Huston v. Iowa Soap Co.,* 85 F. 2d 439 (C.C.A. 6th), certiorari denied, 299 U.S. 594. In *Staley v. Hopkins,* 9 F. 2d 976 (N.D. Tex.), an injunction was denied to prevent seizure and sale by the Collector of plaintiff's homestead in satisfaction of a tax claimed to be due from his wife. A plea that plaintiff was without funds to pay the tax

demanded and that distraint would have destroyed his credit and business was not sufficient to warrant such jurisdiction in *Thornhill Wagon Co. v. Noel,* 17 F. 2d 407 (E.D. Va.). Mere inconvenience to taxpayer in the administration of a trust estate, usually a matter for equitable jurisdiction, did not void the prohibition in *Reinecke v. Peacock,* 3 F. 2d 583 (C.C.A. 7th). On the same day that the Supreme Court in *Child Labor Tax case,* 259 U.S. 20, held the child labor tax unconstitutional, it held in *Bailey v. George, supra,* that the prohibition of the statute forbade restraining the collection of such unconstitutional exaction.

Taxpayer here in his bill for injunction did not allege specificially and in detail facts and circumstances which, reasonably interpreted, might have constituted unusual and extraordinary facts and circumstances resulting in hardship and rendering the statutory remedy at law inadequate, but merely pleaded ultimate facts and conclusions of law. It is elementary that only material facts well pleaded are admitted in a motion to dismiss. Thus, none of the ultimate facts or conclusions of law alleged were admitted.

Taxpayer has a plain, adequate, and complete remedy at law by paying the taxes and then filing claims for refund and later instituting suit upon the rejection of the refund claim. His suit against a Collector in the California federal court, *supra,* for social security taxes paid by him for 1937 is undeniable proof and demonstration of the accuracy of this statement.

CONCLUSION.

In view of the foregoing, it is respectfully submitted that the order of the court below granting the Collector's motion to dismiss should be affirmed.

Dated, October 21, 1942.

Respectfully submitted,

SAMUEL O. CLARK, JR.,
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4

No. 10,191

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

N. N. S. MATCOVICH,

Appellant,

vs.

RICHARD NICKELL, as Collector of Internal Revenue for the First District of California,

Appellee.

APPELLANT'S CLOSING BRIEF.

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PERNAU-WALSH PRINTING CO., SAN FRANCISCO

No. 10,191

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

N. N. S. MATCOVICH,
Appellant,

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Appellee.

APPELLANT'S CLOSING BRIEF.

Under the head of "Summary of Argument" on page 6 of his brief, appellee says, "The bill discloses that the dancing ladies were procured by tax payer." A similar statement is made on page 8 under the head "Argument". There is nothing in the complaint, however, that sustains this statement and it is, therefore, not correct.

The bill of complaint sets out in full the agreement between the plaintiff and these ladies. This agreement states definitely that the relationship is that of licensee and licensor and provides that the ladies pay for the

privilege of dancing. (Tr. page 4.) The complaint also states, "That no other agreement of any kind was ever entered into between said plaintiff and said ladies." (Tr. page 5.) The allegations, together with those set out in our opening brief, show the relationship. The relationship is a question of fact. The motion to dismiss admits these facts and the appellee is bound thereby. Obviously, if the relationship of licensor and licensee exists, the tax levied is certainly illegal.

We do not think anything would be gained by a review of the cases cited by appellee, since the rule is quite definitely established by the two cases cited in our opening brief.

On page 11 of appellee's brief, some reference is made to another suit brought by plaintiff herein against the former collector, Anglim. However, the only matters that this Court can consider at this time are those stated in the complaint. We might say, however, that where the appellee permitted the accumulation of alleged taxes for a three year period without taking any steps to enforce the collection and plaintiff did not make those payments because he relied upon a State Court decision in his favor holding that the relation of employer and employee did not exist, the equities here involved are entirely different from those involved in the earlier case. That case is now on appeal to this Court. The accumulations of the taxes for a period of three years reached an amount that plaintiff was unable to pay.

The admitted facts are:

That before the ladies were permitted to dance a license agreement was entered into. (Tr. page 4.) That no other agreement was entered into. (Tr. page 5.) That said ladies during said period danced in said premises under the license issued to them by plaintiff and by and under no other agreement or arrangement. (Tr. page 5.) That said agreement expressly provided that it was the intent that licensee should not become an employee and not subject to plaintiff's control. (Tr. page 4.) That she paid for the privilege of dancing. (Tr. page 4.) These admitted facts show that no relation of employer and employee existed and hence there could be no tax levied.

It is also admitted:

That plaintiff has no plain, speedy or adequate remedy at law except to pay and then sue. (Tr. page 5.) That plaintiff is unable to pay the said tax assessed without working serious and irreparable damage to his property and business, which could not be subsequently remedied by the recovery of this tax by suit after payment. (Tr. page 6.)

That if defendant seizes and distrains the property of plaintiff and sells the same, plaintiff's entire business will be lost and destroyed, which will result in irreparable damage to him. (Tr. page 6.) Facts are then stated giving the reason for nonpayment and that a large accumulation resulted which plaintiff is unable to pay. (Tr. pages 6-8.)

Under the rule laid down in *Midwest Haulers v. Brady,* 128 F. (2d) 496 (C.C.A. 6th), these admitted facts justify the intervention of equity.

Dated, Sacramento, California,
October 30, 1942.

Respectfully submitted,
R. H. Schwab,
Attorney for Appellant.

No. 10198

United States
Circuit Court of Appeals
For the Ninth Circuit.

CONSOLIDATED CHOLLAR GOULD & SAVAGE MINING COMPANY, a Corporation,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Transcript of the Record

Upon Petition to Review a Decision of the United States Board of Tax Appeals

ROTARY COLORPRINT, 590 FOLSOM ST., SAN FRANCISCO

No. 10198

United States
Circuit Court of Appeals
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CONSOLIDATED CHOLLAR GOULD & SAVAGE MINING COMPANY, a Corporation,
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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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For Taxpayer:
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HARRY HORROW, Esq.

Docket No. 104195

CONSOLIDATED CHOLLAR GOULD & SAVAGE MINING COMPANY,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DOCKET ENTRIES

1940

Aug. 10—Petition received and filed. Taxpayer notified. Fee paid.

Aug. 12—Copy of petition served on General Counsel.

Aug. 10—Request for Circuit hearing in San Francisco, Calif., filed by taxpayer. 8/12/40 copy served.

Sept. 3—Notice of appearance of William A. Boekel as counsel for taxpayer filed.

Oct. 1—Answer filed by General Counsel.

Oct. 4—Copy of answer served on taxpayer.

Docket Entries—(Continued)

1941

April 8—Hearing set June 16, 1941, San Francisco, California.

June 27—Hearing had before Mr. Kern on the merits. Submitted. (Consolidated.) Appearance of John D. Gallaher filed at hearing. Briefs due 8/11/41. Reply briefs due 9/10/41.

July 14—Transcript of hearing June 27, 1941, filed.

Aug. 11—Brief filed by taxpayer. 8/12/41 copy served.

Aug. 11—Brief filed by General Counsel.

Sept. 10—Reply brief filed by taxpayer. 9/11/41 copy served.

Sept. 10—Reply brief filed by General Counsel.

1942

Feb. 4—Findings of fact and opinion rendered. Kern, #16. Decisions will be entered pursuant to Rule 50. 2/7/42 copy served.

Mar. 4—Computation as to deficiency filed by General Counsel.

Mar. 5—Hearing set April 8, 1942, on settlement.

Mar. 23—Consent to settlement filed by taxpayer.

Mar. 25—Decision entered. Arundell, Div. 7.

June 24—Petition for review by U. S. Circuit Court, 9th Circuit, and statement of points filed by taxpayer.

June 24—Proof of service filed. [1*]

*Page numbering appearing at top of page of original certified Transcript of Record.

Docket Entries—(Continued)

1942

June 24—Designation of contents of record filed by taxpayer. Proof of service thereon.

June 26—Proof of service of petition for review filed.

July 6—Certified copy of order from the 9th Circuit re transmission of certain original exhibits designated as Exhibits Nos. P-1, P-2, P-3, and P-4, received in evidence in lieu of copies to be safely kept by the Clerk of this Court and to be returned to the Clerk of the Board of Tax Appeals upon the final decision filed. [2]

Docket No. 105095

CONSOLIDATED CHOLLAR GOULD & SAVAGE MINING COMPANY, a corporation,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DOCKET ENTRIES

1940

Oct. 7—Petition received and filed. Taxpayer notified. Fee Paid.

Oct. 7—Copy of petition served on General Counsel.

Docket Entries—(Continued)

1940

Oct. 7—Request for Circuit hearing in San Francisco, California, filed by taxpayer. 10/7/40 copy served.

Dec. 4—Answer filed by General Counsel.

Dec. 10—Copy of answer served on taxpayer. San Francisco, Calif.

1941

April 8—Hearing set June 16, 1941, San Francisco, California.

June 27—Hearing had before Mr. Kern on the merits. Submitted. (Consolidated.) Appearance of John D. Gallaher filed at hearing. Briefs due 8/11/41. Reply briefs due 9/10/41.

July 14—Transcript of hearing June 27, 1941, filed.

Aug. 11—Brief filed by taxpayer. 8/12/41 copy served.

Aug. 11—Brief filed by General Counsel.

Sept. 10—Reply brief filed by taxpayer. 9/12/41 copy served.

Sept. 10—Reply brief filed by General Counsel.

1942

Feb. 4—Findings of fact and opinion rendered. Kern, #16. Decision will be entered pursuant to Rule 50. 2/7/42 copy served.

Mar. 4—Computation as to deficiency filed by General Counsel.

Mar. 5—Hearing set April 8, 1942, on settlement.

Docket Entries—(Continued)

1942

Mar. 23—Consent to settlement filed by taxpayer.

Mar. 25—Decision entered. Arundell, Div. 7.

June 24—Petition for review by U. S. Circuit Court, 9th Circuit, and statement of points filed by taxpayer.

June 24—Proof of service filed. [3]

June 24—Designation of contents of record filed by taxpayer. Proof of service thereon.

June 26—Proof of service of petition for review filed.

July 6—Certified copy of order from the 9th Circuit re transmission of certain original exhibits designated as Exhibits Nos. P-1, P-2, P-3, and P-4, received in evidence in lieu of copies to be safely kept by the Clerk of this Court and to be returned to the Clerk of the Board of Tax Appeals upon the final decision filed. [4]

United States Board of Tax Appeals

Docket No. 104195

CONSOLIDATED CHOLLAR GOULD & SAVAGE MINING COMPANY, a corporation,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency, San Francisco Division IRA:90-D DCE (C:TS:PD:SF:CCG) dated May 14, 1940, and as a basis of its proceeding alleges as follows:

1. The Petitioner is a corporation organized under and by virtue of the laws of the State of California, with its principal office at Room 1122 Kohl Building, California and Montgomery Streets, San Francisco, California. The return for the period here involved was filed with the collector for the first district of California.

2. The notice of deficiency a copy of which together with the statement of the internal revenue agent in charge accompanying the same is attached hereto and marked Exhibit "A", was mailed to the petitioner on or about May 14, 1940. [5]

3. The taxes in controversy are income taxes

for the calendar year 1936 and in the amount of approximately $2,710.89.

4. The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(a) The Commissioner erred in disallowing percentage depletion allowable under section 114(b)(4) of the Revenue Act of 1936 in the sum of $8,907.06.

(b) The Commissioner erred in holding as a matter of law that no percentage depletion under said section is allowable on the income derived from so-called mining dumps.

(c) The Commissioner erred in finding as a matter of fact that the precious metals derived from said so-called dumps were not a natural deposit.

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) Petitioner is a consolidated corporation created by the consolidation under and by virtue of the laws of the State of California on or about the 25th day of February, 1933, of Chollar Gold and Silver Mining Company, Gould and Curry Mining Company and Savage Gold and Silver Mining Company, all corporations organized under the laws of the State of California.

(b) On or about the 1st day of July, 1933, Bullion Gold and Silver Mining Company acquired by deed from Sutro Tunnel Coalition, Inc. and James O. Leonard, and on or about said date petitioner acquired from said Bullion Gold and Silver Mining

Company, by purchase, property known and referred to as the American Flat Property, upon which the mines and dumps hereinafter [6] mentioned are located at Virginia City in the State of Nevada, and petitioner was at all times during the year 1936 the owner in fee thereof.

(c) Prior thereto the predecessors of said Bullion Gold and Silver Mining Company and of its predecessors Sutro Tunnel Coalition, Inc. and James O. Leonard, had removed from said mines a quantity of natural deposit ore material and deposited and placed the same adjacent to said mines.

(d) Said material adjacent to said mines was upon said property at the time of the acquisition thereof by petitioner, known and referred to as the Yellow Jacket and Belcher dumps, and was included in said purchase as a part of said mines and appurtenances purchased from said Bullion Gold and Silver Mining Company.

(e) During the calendar year 1936 petitioner processed said material constituting said so-called dumps and removed precious metals therefrom, and derived income therefrom which is the subject matter of this proceeding.

(f) During said calendar year 1936 petitioner paid royalties of $1,801.33 to Sutro Tunnel Coalition, Inc. for the use of a drainage tunnel in connection with said properties and the sum of $1,235.77 to Minerals Separation Company for the use of a milling process by which said so-called dumps were processed on the basis of one cent per ton for

each ton of ore milled during said year, and other royalties for other purposes.

(g) Petitioner filed its first income tax return for the calendar year 1933 and elected at the time of making said return to have the depletion allowance for such property for the [7] taxable year 1934 and subsequent taxable years computed with regard to percentage depletion under the provisions of section 114(b)(4) of the Revenue Act of 1932, and endorsed upon said return the following:

> "Consolidated Chollar Gould & Savage Mining Company elects to have the depletion allowance on the American Flat Property, now owned and operated by it, for the year 1934 and subsequent taxable years, computed on the basis of percentage depletion."

Petitioner filed an income tax return for the year 1934 and again elected at the time of making said return to have the depletion allowance for the taxable year 1934 and subsequent taxable years computed with regard to said percentage depletion under the provisions of section 114(b)(4) of the Revenue Act of 1934, and endorsed upon said return the following:

> "Consolidated Chollar Gould & Savage Mining Company elects to have the depletion allowance on the American Flat Property, now owned and operated by it, for the year 1934 and subsequent taxable years, computed on the basis of percentage depletion."

In said return for the year 1936, petitioner computed depletion upon said properties upon a percentage basis in accordance with said election.

(h) Said material constituting said so-called dumps was removed from said mines and left adjacent thereto by the predecessors of said Bullion Gold and Silver Mining Company, Sutro Tunnel Coalition, Inc. and James O. Leonard, during the period [8] from the year 1860 to the year 1928, and petitioner is informed and believes and upon its information and belief alleges that all or substantially all thereof was removed and left adjacent to said mines between the years 1860 and 1913.

(i) Said predecessors of petitioner removed said ore material from said mines and left the same adjacent thereto without any attempt to process the same or remove the precious metals therefrom, and said precious metals therein were at all times until removed therefrom by petitioner in the year 1936 still in place and naturally deposited in said material.

(j) No income tax depletion allowance was ever claimed at any time by any of the predecessors of petitioner with respect to said ore material.

Wherefore, the petitioner prays that this Board may hear the proceeding and may find and rule that petitioner is entitled to said depletion allowance and that there is no deficiency tax due from petitioner for the calendar year 1936, and for such

other and further orders or relief as are appropriate in the premises.

WILLIAM A. BOEKEL,
Counsel.
604 Federal Reserve Bank Building,
San Francisco, California.
JOHN CUMMINGS,
Counsel.
760 Russ Building,
San Francisco, California. [9]

(Duly verified) [10]

EXHIBIT A

Form 1230 SN-IT-1

TREASURY DEPARTMENT

Internal Revenue Service

433 Federal Office Building,
San Francisco, California

Office of
Internal Revenue Agent in Charge
San Francisco Division May 14, 1940.
IRA:90-D
DCE
(C:TS:PD:
SF:CCG)

Consolidated Chollar Gould &
Savage Mining Company,
1122 Kohl Building,
San Francisco, California.

Gentlemen:

You are advised that the determination of your income tax liability for the taxable year ended December 31, 1936 discloses a deficiency of $3,625.45 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, San Francisco, California for the attention of — Conference Section —. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

GUY T. HELVERING, Commissioner.

H.J.B. By F. M. HARLESS,

Internal Revenue Agent in Charge.

Enclosures:

Statement.

Form of waiver. [11]

STATEMENT

San Francisco
IRA:90-D
DCE
(C:TS:PD
SF:CCG)

Consolidated Chollar Gould & Savage Mining Company,

1122 Kohl Building,

San Francisco, California

Tax Liability for the Taxable Year Ended December 31, 1936

	Liability	Assessed	Deficiency
Income Tax	$6,086.44	$2,460.99	$3,625.45

In making this determination of your income tax liability, careful consideration has been given to your protest dated September 27, 1939, and to the statements made at the conferences held on October 27, 1939, February 13, 1940, March 8, 1940, and March 29, 1940.

A copy of this letter and statement has been mailed to your representative, Mr. John Cummings, 760 Russ Building, San Francisco, California, in accordance with the authority contained in the power of attorney executed by you and on file in this office.

ADJUSTMENTS TO NET INCOME

Net income as disclosed by return	$11,305.35
Unallowable deductions and additional income:	
(a) Depletion	11,305.35
Net income adjusted	$22,610.70

[12]

EXPLANATION OF ADJUSTMENTS

(a) You have elected to have depletion computed on the basis of percentage depletion under the provisions of Section 114(b) (4) of the Revenue Act of 1936. On your return there was deducted $11,305.35 as depletion, said amount representing 50% of the net income reported from all operations.

The net taxable income of $22,610.70 was derived from the following sources:

Profit from milling dump ores	$71,211.40	
Loss from mining operations	53,397.29	
Net taxable income, company operations		$17,814.12
Profit from treating ores purchased on a royalty basis:		
From: Consolidated Virginia Mining Co.	$ 3,687.74	
George K. Allen	1,108.84	4,796.58
Total net income		$22,610.70

You are in agreement that the profit in the total amount of $4,796.58 derived from milling ores not mined by you but purchased in consideration of royalty payments must be excluded in computing net income for the purpose of determining allowable depletion. It is your present contention that

since 15% of the gross income from all company ores treated is greater than 50% of the net operating income of $17,814.12, which amount includes a profit derived from milling dump ores, you are entitled to $8,907.06 as a deduction for depletion.

It is held that since mining operations resulted in a loss, no depletion is allowable under section 114(b) (4) of the Revenue Act of 1936. [13]

COMPUTATION OF TAX

Excess-profits Tax:	
Taxable net income	$22,610.70
Less:	
10% of $517,457.50 value of capital stock as declared in your capital stock tax return for year ended June 30, 1936	51,745.75
Net income subject to excess-profits tax	$ None
Income Tax:	
Normal tax:	
Taxable net income	$22,610.70
8% of $ 2,000.00 (Over 0 to $ 2,000)	$ 160.00
11% of $13,000.00 (Over $ 2,000 to $15,000)	1,430.00
13% of $ 7,610.70 (Over $15,000 to $40,000)	989.39
Total normal tax	$ 2,579.39
Surtax on Undistributed Profits:	
Taxable net income	$22,610.70
Less: Normal tax	2,579.39
Undistributed adjusted net income	$20,031.31
Less: Specific credit	2,996.87
Remainder subject to surtax	$17,034.44

[14]

COMPUTATION OF TAX—(Continued)

7% of $2,003.13	$ 140.22
12% of 2,003.13	240.38
17% of 4,006.26	681.06
22% of 4,006.26	881.38
27% of 5,015.66	1,354.23
Amount of Tax	$ 3,297.27
Plus:	
7% of $2,996.87 (specific credit)	209.78
Total surtax	$ 3,507.05
Normal tax	2,579.39
Total income tax (normal tax and surtax)	$ 6,086.44
Income tax assessed (normal tax and surtax):	
Original, account No. 401704	
First California District	2,460.99
Deficiency of income tax	$ 3,625.45

[Endorsed]: U.S.B.T.A. Filed Aug. 10, 1940. [15]

[Title of Board and Cause—Docket No. 104195.]

ANSWER

Comes now the Commissioner of Internal Revenue, respondent above named, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed by the above-named petitioner admits and denies as follows:

1. Admits the allegations contained in paragraph 1 of the petition.

2. Admits the allegations contained in paragraph 2 of the petition.

3. Admits that the tax in controversy is income tax for the calendar year 1936; denies the remaining allegations contained in paragraph 3 of the petition.

4(a) to (c), inclusive. Denies that the Commissioner erred as alleged in subparagraphs (a) to (c), inclusive, of paragraph 4 of the petition. [16]

5(a) and (b). Admits the allegations contained in subparagraphs (a) and (b) of paragraph 5 of the petition.

5(c). Admits that prior thereto the predecessors of said Bullion Gold and Silver Mining Company and Sutro Tunnel Coalition, Inc. and James O. Leonard had removed from said mines a quantity of ore material; denies the remaining allegations contained in subparagraph (c) of paragraph 5 of the petition.

5(d). Admits that the petitioner acquired by purchase certain materials known as the Yellow Jacket and Belcher dumps; denies the remaining allegations contained in subparagraph (d) of paragraph 5 of the petition.

5(e) and (f). Admits the allegations contained in subparagraphs (e) and (f) of paragraph 5 of the petition.

5(g). Admits the allegations contained in subparagraph (g) of paragraph 5 of the petition except that the allegations contained in the last sentence of said subparagraph are denied.

5(h). Admits that the material constituting said dumps was removed from said mines by the prede-

cessors of said Bullion Gold and Silver Mining Company, Sutro Tunnel Coalition, Inc. and James O. Leonard prior to 1928; denies the remaining allegations contained in subparagraph (h) of paragraph 5 of the petition.

5(i) and (j). Denies the allegations contained in subparagraphs (i) and (j) of paragraph 5 of the petition. [17]

6. Denies generally and specifically each and every allegation in the petition not hereinbefore admitted, qualified or denied.

Wherefore, it is prayed that the Commissioner's determination be approved and the petitioner's appeal denied.

(Signed) J. P. WENCHEL,
T. M. M.
Chief Counsel, Bureau of Internal Revenue.

Of Counsel:
ALVA C. BAIRD,
Division Counsel.

T. M. MATHER,
HARRY R. HORROW,
Special Attorneys,
Bureau of Internal Revenue.

HRH:sob 9/24/40.

[Endorsed]: U.S.B.T.A. Filed Oct. 1, 1940. [18]

United States Board of Tax Appeals

Docket No. 105095

CONSOLIDATED CHOLLAR GOULD & SAVAGE MINING CO., a corporation,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION

The above named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency, San Francisco Division IRA: 90-D dated July 11, 1940, and as a basis of its proceeding alleges as follows:

1. The Petitioner is a corporation organized under and by virtue of the laws of the State of California, with its principal office at Room 1122 Kohl Building, California and Montgomery Streets, San Francisco, California. The return for the period here involved was filed with the collector for the first district of California.

2. The notice of deficiency a copy of which together with the statement of the internal revenue agent in charge accompanying the same is attached hereto and marked Exhibit "A", was mailed to the petitioner on or about July 11, 1940. [19]

3. The taxes in controversy are income taxes

for the calendar year 1938 and in the amount of approximately $655.45.

4. The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(a) The Commissioner erred in disallowing percentage depletion allowable under section 114(b)(4) of the Revenue Acts of 1934, 1936, 1938 in the sum of $4,543.53.

(b) The Commissioner erred in holding as a matter of law that no percentage depletion under said section is allowable on the income derived from so-called mining dumps.

(c) The Commissioner erred in finding as a matter of fact that the precious metals derived from said so-called dumps were not a natural deposit.

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) Petitioner is a consolidated corporation created by the consolidation under and by virtue of the laws of the State of California on or about the 25th day of February, 1933, of Chollar Gold and Silver Mining Company, Gould and Curry Mining Company and Savage Gold and Silver Mining Company, all corporations organized under the laws of the State of California.

(b) On or about the 1st day of July, 1933, Bullion Gold and Silver Mining Company acquired by deed from Sutro Tunnel Coalition, Inc. and James O. Leonard, and on or about said date petitioner acquired from said Bullion Gold [20] and

Silver Mining Company, by purchase, property known and referred to as the American Flat Property, upon which the mines and dumps hereinafter mentioned are located at Virginia City in the State of Nevada, and petitioner was at all times during the year 1938 the owner in fee thereof.

(c) Prior thereto the predecessors of said Bullion Gold and Silver Mining Company and of its predecessors Sutro Tunnel Coalition, Inc. and James O. Leonard, had removed from said mines a quantity of natural deposit ore material and deposited and placed the same adjacent to said mines.

(d) Said material adjacent to said mines was upon said property at the time of the acquisition thereof by petitioner, known and referred to as the Yellow Jacket and Belcher dumps, and was included in said purchase as a part of said mines and appurtenances purchased from said Bullion Gold and Silver Mining Company.

(e) During the calendar year 1936, petitioner processed a portion of said material constituting said so-called dumps and removed precious metals therefrom and derived income therefrom which is the subject matter of proceeding No. 104195 now pending before the Board of Tax Appeals. During the calendar year 1938, petitioner processed a portion of said material constituting said so-called dumps and removed precious metals therefrom and derived income therefrom which is the subject matter of this proceeding. [21]

(f) During said calendar year 1938, petitioner

became liable for accrued royalties of $1,215.39 to Minerals Separation North American Corporation for the use of a milling process by which said so-called dumps were processed, and for the further sum of $9,212.52, accrued royalties, to Comstock Tunnel and Drainage Company for the use of a tunnel in connection with the said properties and other royalties for other purposes.

(g) Petitioner filed its first income tax return for the calendar year 1933 and elected at the time of making said return to have the depletion allowance for such property for the taxable year 1934 and subsequent taxable years computed with regard to percentage depletion under the provisions of section 114(b)(4) of the Revenue Act of 1932, and endorsed upon said return the following:

> "Consolidated Chollar Gould & Savage Mining Company elects to have the depletion allowance on the American Flat Property, now owned and operated by it, for the year 1934 and subsequent taxable years, computed on the basis of percentage depletion."

Petitioner filed an income tax return for the year 1934 and again elected at the time of making said return to have the depletion allowance for the taxable year 1934 and subsequent taxable years computed with regard to said percentage depletion under the provisions of section 114(b)(4) of the Revenue Act of 1934, and endorsed upon said return the following: [22]

"Consolidated Chollar Gould & Savage Mining Company elects to have the depletion allowance on the American Flat Property, now owned and operated by it, for the year 1934 and subsequent taxable years, computed on the basis of percentage depletion."

In said return for the year 1938, petitioner computed depletion upon said properties upon a percentage basis in accordance with said election.

(h) Said material constituting said so-called dumps was removed from said mines and left adjacent thereto by the predecessors of said Bullion Gold and Silver Mining Company, Sutro Tunnel Coalition, Inc. and James O. Leonard, during the period from the year 1860 to the year 1928, and petitioner is informed and believes and upon its information and belief alleges that all or substantially all thereof was removed and left adjacent to said mines between the years 1860 and 1913.

(i) Said predecessors of petitioner removed said ore material from said mines and left the same adjacent thereto without any attempt to process the same or remove the precious metals therefrom, and said precious metals in the portion thereof processed during the year 1938 were at all times until removed therefrom by petitioner in the year 1938 still in place and naturally deposited in said material.

(j) No income tax depletion allowance was ever

claimed at any time by any of the predecessors of petitioner with respect to said ore material. [23]

Wherefore, the petitioner prays that this Board may hear the proceeding and may find and rule that petitioner is entitled to said depletion allowance and that there is no deficiency tax due from petitioner for the calendar year 1938, and for such other and further orders or relief as are appropriate in the premises.

WILLIAM A. BOEKEL,
Counsel.
604 Federal Reserve Bank
Building,
San Francisco, California.

JOHN CUMMINGS,
Counsel,
760 Russ Building,
San Francisco, California.

[24]

(Duly verified.) [25]

EXHIBIT "A"

Form 1230 SN-IT-1

TREASURY DEPARTMENT
Internal Revenue Service
433 Federal Office Building
San Francisco, California

Office of Jul 11 1940
Internal Revenue Agent in Charge
San Francisco Division

IRA:90-D
GK

Consolidated Chollar Gould &
Savage Mining Company,
1122 Kohl Building,
San Francisco, California.

Sirs:

You are advised that the determination of your income tax liability for the taxable year(s) ended December 31, 1938 discloses a deficiency of $676.59 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, San

Francisco, California for the attention of—Conference Section—. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,
GUY T. HELVERING,
Commissioner,
By (Sgd.) F. M. HARLESS,
Internal Revenue Agent in Charge.

Enclosures:
Statement.
Form of waiver. [26]

STATEMENT

San Francisco
IRA:90-D
GK

Consolidated Chollar Gould &
Savage Mining Company,
1122 Kohl Building,
San Francisco, California

Tax Liability for the Taxable Year Ended December 31, 1938

	Liability	Assessed	Deficiency
Income tax	$1,244.53	$ 567.94	$ 676.59

In making this determination of your income tax

liability, it is noted that you did not avail yourself of the privilege of filing a protest.

ADJUSTMENTS TO NET INCOME

Net income as disclosed by return			$4,543.52
Unallowable deductions and additional income:			
(a)	Depletion disallowed	$4,543.53	
(b)	Loss on trade of automobile	338.20	4,881.73
Net income adjusted			$9,425.25

EXPLANATION OF ADJUSTMENTS

(a) You claimed in your return a deduction of $4,543.53 for depletion, this amount being fifty per cent of your reported net income before deducting depletion, and less than fifteen per cent of the net value of ore produced during the year.

Information received by this office indicates that actual mining operations conducted during 1938 resulted in a loss and that your net income for the year was derived from the milling of dump ores.

It is noted that you have elected to have the depletion allowance computed with regard to percentage depletion under the provisions of section 114(b)(4) of the Revenue Acts of 1934, 1936 and 1938. Since your mining operations resulted in a loss, no depletion is allowable for 1938. [27]

Consolidated Chollar Gould & Savage Mining Company — Statement

EXPLANATION OF ADJUSTMENTS
(Continued)

(b) A loss of $338.20 was claimed by you on

the trade of an automobile truck used in your business in the purchase of like equipment during 1938. Section 112(b)(1) of the Revenue Act of 1938 provides that such losses shall not be recognized for income tax purposes.

COMPUTATION OF TAX

Excess-profits Tax:		
Taxable net income		$ 9,425.25
Less:		
Dividends received credit	None	
10% of $1,000,000.00 value of capital stock as declared in your capital stock tax return for year ended June 30, 1938	$100,000.00	100,000.00
Net income subject to excess-profits tax		None
Total excess-profits tax		None

COMPUTATION OF INCOME TAX
(Corporations with Net Incomes of Not More Than $25,000.00)

Net income for excess-profits tax computation	$9,425.25
Less: Excess-profits tax	None
Net income	$9,425.25
Less: Interest on obligations of the United States, etc.	None
Adjusted net income	$9,425.25
Dividends received credit (85 per cent of dividends received but not in excess of 85 per cent of adjusted net income)	None
Balance subject to income tax	$9,425.25

COMPUTATION OF TAX—(Continued)

Portion (not in excess of $5,000) taxable at 12½%	$5,000.00	12½%	$ 625.00
Portion (in excess of $5,000 and not in excess of $20,000) taxable at 14%	4,425.25	14 %	619.53
Portion (in excess of $20,000) taxable at 16%	None		None
Total income tax			$1,244.53
Less: Credit for income taxes paid to a foreign country or United States possession allowed to a domestic corporation			None
Total income tax assessable			$1,244.53
Income tax assessed:			
Original, account No. 400558—First California			567.94
Deficiency of income tax			$ 676.59

[Endorsed]: U.S.B.T.A. Filed Oct. 7, 1940. [29]

United States Board of Tax Appeals

CONSOLIDATED CHOLLAR GOULD & SAVAGE MINING COMPANY, A Corporation,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

[Title of Board and Cause—Docket No. 105095.]

ANSWER

Comes now the Commissioner of Internal Revenue, respondent above named, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed by the above-named petitioner admits and denies as follows:

1. Admits the allegations contained in paragraph 1 of the petition.

2. Admits the allegations contained in paragraph 2 of the petition.

3. Admits that the tax in controversy is income tax for the calendar year 1938; denies the remaining allegations contained in paragraph 3 of the petition.

4(a) to (c), inclusive. Denies that the Commissioner erred as alleged in subparagraphs (a) to (c), inclusive, of paragraph 4 of the petition. [30]

5(a) and (b). Admits the allegations contained in subparagraphs (a) and (b) of paragraph 5 of the petition.

5(c). Admits that prior thereto the predecessors of said Bullion Gold and Silver Mining Company and Sutro Tunnel Coalition, Inc. and James O. Leonard had removed from said mines a quantity of ore material; denies the remaining allegations

contained in subparagraph (c) of paragraph 5 of the petition.

5(d). Admits that the petitioner acquired by purchase certain materials known as the Yellow Jacket and Belcher dumps; denies the remaining allegations contained in subparagraph (d) of paragraph 5 of the petition.

5(e). Admits the allegations contained in subparagraph (e) of paragraph 5 of the petition.

5(f). Denies the allegations contained in subparagraph (f) of paragraph 5 of the petition.

5(g). Admits the allegations contained in subparagraph (g) of paragraph 5 of the petition except that the allegations contained in the last sentence of said subparagraph are denied.

5(h). Admits that the material constituting said dumps was removed from said mines by the predecessors of said Bullion Gold and Silver Mining Company, Sutro Tunnel Coalition, Inc. and James O. Leonard prior to 1928; denies the remaining allegations contained in subparagraph (h) of paragraph 5 of [31] the petition.

5(i) and (j). Denies the allegations contained in subparagraphs (i) and (j) of paragraph 5 of the petition.

6. Denies generally and specifically each and every allegation in the petition not hereinbefore admitted, qualified or denied.

Wherefore, it is prayed that the Commissioner's determination be approved and the petitioner's appeal denied.

(Signed) J. P. WENCHEL,
H. R. H.
J. P. WENCHEL,
Chief Counsel,
Bureau of Internal Revenue.

Of Counsel:
ALVA C. BAIRD,
Division Counsel.

T. M. MATHER,
HARRY R. HORROW,
Special Attorneys,
Bureau of Internal Revenue.

HRH:sob 11/29/40.

[Endorsed]: U.S.B.T.A. Filed Dec. 4, 1940. [32]

[Title of Board and Cause—Dockets Nos. 104195, 105095.]

TRANSCRIPT OF PROCEEDINGS

Post Office Building,
San Francisco, California
June 27, 1941.
2:00 o'clock p. m.

Before: Hon. John W. Kern,
Met pursuant to notice.

APPEARANCES

JOHN D. GALLAHER and
WILLIAM A. BOEKEL,
604 Federal Reserve Bank Building,
San Francisco, California.

JOHN CUMMINGS,
760 Russ Building,
San Francisco, California,
appearing for Consolidated Chollar Gould & Savage Mining Company, the Petitioner. [34]

HARRY R. HORROW,
appearing for the Commissioner of Internal Revenue, Respondent. [35]

PROCEEDINGS

The Member: Consolidated Chollar Gould & Savage Mining Company.

Are the parties ready?

Mr. Horrow: Ready for Respondent, your Honor.

Mr. Gallaher: Ready for Petitioner.

The Member: Will counsel note their appearances in the record.

Mr. Gallaher: The appearances for the Petitioner are John D. Gallaher, William A. Boekel, and John Cummings.

William A. Boekel is an attorney at law who is counsel of record for the Petitioner. I am employed in his office. John Cummings is a certified public accountant.

I believe it is not necessary but I have a power of attorney running to myself, William A. Boekel and John Cummings which I would ask leave to file in the record.

The Clerk: Are you admitted to practice before the Board?

Mr. Gallaher: Yes, sir, I am admitted to practice before the Board.

Mr. Horrow: Harry R. Horrow for the Respondent.

The Member: May I have a short statement as to the issues that are involved?

Mr. Gallaher: Yes. [37]

STATEMENT OF CASE ON BEHALF OF THE PETITIONER

Mr. Gallaher: If your Honor please, in both of these matters the issues are precisely the same. This is an appeal from an assessment of an addi-

tional tax for the year 1936 and also for the year 1938.

The Petitioner in this matter is a mining company which in 1933 purchased certain mining properties near Virginia City, Nevada. There were on the property some so-called dumps which consisted of rock taken many years ago from adjacent mines and placed upon the lands. During the years 1936 and 1938 the Petitioner processed the dumps and extracted precious metals therefrom. The petitioner has claimed percentage depletion with respect to those operations.

The Commissioner has disallowed the claim of percentage depreciation on the ground that this transaction amounted to the reprocessing of tailings or the processing of tailings.

The issue here is whether or not the processing of that rock, which had never been processed before, is the processing of tailings within the meaning of the cases that hold that in the case of the processing of tailings a percentage depletion is not allowable. That is the principal issue in the case.

A larger part of the facts involved have been stipulated [38] to.

It is stipulated that the Petitioner is a corporation organized under the laws of California with its principal office at 1122 Kohl Building.

The Member: Has there been a written stipulation prepared?

Mr. Gallaher: No; I mean to say that these facts are admitted by the answer.

The Member: Oh, I see.

Mr. Gallaher: The corporate existence of the Petitioner is admitted by the answer. The deficiency notices are admitted by the answer.

It is admitted by the answer that on or about the first day of July 1933, Bullion Gold and Silver Mining Company acquired by deed from Sutro Tunnel Coalition, Inc., and James O. Leonard, and on or about said date Petitioner acquired from said Bullion Gold and Silver Mining Company, by Purchase, property known and referred to as the American Flat Property, upon which the mines and dumps hereinafter mentioned are located at Virginia City in the State of Nevada, and Petitioner was at all times during the year 1938 the owner in fee thereof.

The petition with respect to the 1936 taxes contains a similar allegation with respect to the year 1936 and that allegation is admitted by the answer. [39]

It is also admitted that prior thereto the predecessors of said Bullion Gold and Silver Mining Company and of its predecessors Sutro Tunnel Coalition, Inc., and James O. Leonard, had removed from said mines a quantity of natural deposit or material. The petition alleges that they deposited and placed the same adjacent to the mines. That part of the petition is denied.

It is also admitted that Consolidated Chollar Gould & Savage Mining Company, the Petitioner herein, did claim percentage depletion upon its return filed for the year 1933 and also for the year

1934 as required by Section 114(b) (4) of the Revenue Act of 1932, and as amended by the Revenue Act of 1934.

The Member: That is the sole issue that is presented?

Mr. Gallaher: I believe that is the sole issue that is presented, whether or not the petitioner is entitled to percentage depletion with respect to the processing of this waste rock which has been referred to as dumps.

The Member: Do you have anything to say, Mr. Horrow?

Mr. Horrow: Yes, your Honor.

STATEMENT OF CASE ON BEHALF OF THE RESPONDENT

Mr. Horrow: There were three types of ore materials that were processed by the Petitioner during the taxable year; one, the ore materials from these dumps which were [40] located on lands acquired by the Petitioner and, two, ore materials that were actually mined by the Petitioner and, three, ore materials which were taken by Petitioner from dumps located on lands belonging to other persons.

We concede that percentage depletion is allowable in respect of income derived from the processing of ore materials which Petitioner mined, the ore materials which were in sight, so to speak.

Now, for 1936 a deficiency notice determined that there was a loss from the mining operations. For 1938 we likewise determined that there was a loss

from the mining operations, but we are prepared to stipulate that net income was derived from the processing of ore materials that were mined by Petitioner and, I believe, we will be able to stipulate as to the amount of that net income during the course of the hearing.

I would like to say, your Honor, that our position is not that depreciation allowance should be denied in respect of the dumps because they are to be characterized as tailings but because they are not a mine and the extraction of the gold and silver content, the ore materials that were in the dumps is not a mining operation. Such materials were not ores in place and no percentage depletion is allowable in respect of any income derived therefrom.

That is our position, your Honor. [41]

The Member: All right. Call your first.

Mr. Gallaher: Mr. Slosson.

The Member: The Clerk has called to my attention the question of whether these cases have been consolidated for hearing and decision.

Mr. Gallaher: It is our desire they be consolidated if that is agreeable.

Mr. Horrow: Yes, your Honor, that is agreeable to Respondent.

The Member: The two cases will be consolidated for hearing and decision.

HENRY L. SLOSSON, JR.

a witness on behalf of Petitioner, was duly sworn and testified as follows:

The Clerk: State your full name, please.

The Witness: Henry L. Slosson, Jr.; S-l-o-s-s-o-n.

Direct Examination

Q. (By Mr. Gallaher): Where do you reside, Mr. Slosson? A. San Francisco.

Q. What is your occupation?

A. Mining Engineer.

Q. How long have you been a mining engineer?

A. For the last 35 years.

Q. You have an office in San Francisco? [42]

A. Yes, sir; 333 Kearny Street.

Q. Are you familiar with the property of the Consolidated Chollar Gould & Savage Mining Company at Virginia City, Nevada?

A. Yes, I am.

Q. How long have you been familiar with that property?

A. I have been familiar with it since 1902 when I first went to the Comstock.

Q. Have you made a study of the mining operations conducted at and near Virginia City?

A. Yes, very carefully.

Q. Will you state what you have done in making a study of those mining operations?

A. I have operated up there myself. I was President of the Mexican Mining Company at the time it had its ore body in 1916.

(Testimony of Henry L. Slosson, Jr.)

The Member: At the time it had its what?

The Witness: At the time it had its ore body in 1916. I was in control of the Yellow Jacket Mine backed by Mr. Clarence Mackey in 1907 right after the earthquake. I had control of the Yellow Jacket. It was adjoining this property I have been through on these deeper levels, through into this Chollar ground and I think I am thoroughly familiar with the details of it.

Q. (By Mr. Gallaher): Do you know of the existence of the [43] so-called dumps that are involved in this matter?

A. Yes, sir; I figured on them myself at one time.

Q. What do you mean by you "figured on them"?

A. I figured that possibly they might be workable. We had them very carefully sampled by Professor Probert of the University Mining School of the University of California, but they were too low.

Q. When was that, Mr. Slosson?

A. 1907 or 1908.

Q. When you say "They were too low" you mean what?

A. Extremely low grade.

Q. Would you be able to say what the analysis showed the grades were?

A. My recollection is they ran from $1.80 to $2.25. That, of course, was the old price of gold.

Q. Do you know when the dumps were removed from the mines and placed where they are now?

(Testimony of Henry L. Slosson, Jr.)

A. They were moved from a period extending from about 1872, when the famous Crown Point bonanza was developed, on to about 1898. Practically nothing was done after that time. The mines were flooded.

Q. Do you know whether or not any of the material constituting those dumps was ever processed?

A. Never processed. That dump was considered practically worthless by those old time miners because at that time the [44] cost of milling was eight or ten dollars a ton; that was prohibitive.

The Member: I call counsel's attention to the fact that the Presiding Member doesn't know what "processing" means. You might ask this witness.

Mr. Gallaher: Yes, if your Honor please.

Q. (By Mr. Gallaher): Will you please explain to the Presiding Member the meaning of the word "processing" with reference to mining?

A. Well, processing, your Honor, is the beginning of the reduction of ore for the purpose of extraction. The first process would be to mill it and pound it into an impalpable dust. From then on the process might vary. At the present date we use cyanide. In those days they worked what is known as pan amalgamation which consisted in amalgamating in the pans with the quicksilver the crushed ore. That process was very expensive but it was the only process known in the '60s and '70s, and, of course, some of these dumps are now commercially profitable which wouldn't be at that time.

(Testimony of Henry L. Slosson, Jr.)

Q. Well, you would say that the processing is the process whereby the precious metal is extracted from the rock?

A. The first step in the processing would be milling. Until you begin to mill your ore you don't process it.

Q. And this rock showed no evidence of ever having been [45] milled?

A. It had never been milled. It was waste rock that came from the mine just as it was blasted. The processing begins at that point, first, the extraction which is not processing and then comes the processing which is reduction.

Q. In the years that you mentioned, that is, from 1871 onward did the mining companies own and operate their own mills as a rule?

A. As a rule not. In early days of the Comstock, in the so-called Bonanza days there was a huge mill ring up there dominated by some very large capitalists in California, among whom D. O. Mills was very prominent. Each mine would contract to have its ore milled. They were independent milling outfits, but at the same time generally that big company known as the Union Mill & Mining Company got all the business.

Q. How far was their mill from the dumps in question?

A. Well, they had 15 or 20 mills but the nearest —there were two or three of the mills that were not far from the dump in question.

(Testimony of Henry L. Slosson, Jr.)

Q. Was it necessary to pay transportation charges on the rock to take it to the mill?

A. As a rule, yes. There was a railroad built for that purpose; that was enormously profitable.

Q. In order to make a profit on extracting the ore what [46] grade rock had to be found in those days?

Mr. Horrow: As of what date, Mr. Gallaher?

Mr. Gallaher: I am addressing myself from 1871 onward, say, to 1901.

The Witness: Will you repeat that question, please?

(The question referred to was read by the reporter as above recorded.)

A. At least $20 underground.

The Member: What do you mean "$20 underground"?

The Witness: $20 of the rock stood in place in the mine would pay possibly a small profit. Today we could mine the same rock at a very much less cost.

Q. (By Mr. Gallaher): Why could you mine it at a less cost today?

A. Because you have got compressed air; you have got electric power which they didn't have in those days. All drilling was done by hand. There was no electric power on the ground. Power was maintained by steam, maintained at a cost of about $20 per horsepower per month. Today you can get

(Testimony of Henry L. Slosson, Jr.)

it for $4.00 per horsepower per month. Vast improvements have been made. The cost of milling was twelve or fifteen dollars for milling and they guaranteed a 65 per cent extraction of the precious metals. The result is $20 rock would just about make the amount even, if you were lucky. [47]

Q. (By Mr. Gallaher): Do you know whether or not the rock constituting these dumps is $20.00 rock? A. The dumps?

Q. Yes.

A. Oh, no. As I say, my samples were from about 85 cents to $2.25 when Professor Probert and I went through.

Q. You could say, then, that the rock could not have been milled in the old days, as you put it, at a profit?

A. Hopeless. They threw it out and never expected it to be touched, those old-timers. They used it to fill up chuck holes in the streets.

Q. Will you explain to the Court the meaning of the word "tailings", used with respect to mining operations?

Mr. Horrow: How is that material, counsel? How is that relevant to the issue presented here?

Mr. Gallaher: Well, I believe that the Commissioner has taken the position that under the regulations and the cases that depletion is not allowable, percentage depletion is not allowable with respect to the processing of tailings.

The Member: Well, let's have the witness testify with regard to it. It may or may not be relevant.

(Testimony of Henry L. Slosson, Jr.)

Mr. Horrow: Very well.

A. The question was on tailings, as I understood it?

Q. (By Mr. Gallaher): Yes.

A. Tailings, your Honor, are the products of the mill after [48] it is crushed into impalpable powder and processed by whatever process may be used. The tailings flow out of the mill and are generally deposited in some place where they won't spread all over the country and there they stay.

Now, the tailings is the product of the mill after the ore has been treated and the dumps are the product of the mine before it has been treated.

Q. Are the dumps in question tailings in any sense of the word?

A. Oh, no, not to any mining engineer.

The Member: Who owned that Union Mill that you were talking about?

The Witness: The Union Mill & Mining Company was a corporation that was formed in '65 or '66. The Bank of California had loaned money on a number of mills up on the Comstock which were custom mills and the Comstock looked very sick about 1864. The ore began to give out. It looked as though the jig was up. Suddenly an ore body was discovered. When the bank found there was liable to be a repetition of riches in depth they foreclosed on all these mills, took them into a syndicate, froze out the old owners. This D. O. Mills, William C. Ralston, Alvinza Hayward and William

(Testimony of Henry L. Slosson, Jr.)

Sharon, who afterwards built the Palace Hotel, they organized this ring and took the whole thing in and it was enormously profitable. They were said to make [49] five or six million dollars per year just on contract milling.

The Member: Any other questions?

Mr. Gallaher: Yes, I have one further question.

Q. (By Mr. Gallaher): Mr. Slosson, when the rock was removed from the mines and deposited where it is now was it changed other than being broken up?

A. No; it came as it was blasted from the mine.

Q. Such metal as is contained in the rock is still naturally deposited in that rock?

A. In the rock.

Mr. Horrow: Just a moment. I object to that on the ground it calls for a conclusion of the witness and is argumentative, your Honor.

The Member: Overruled.

Mr. Gallaher: The question was whether the ore is still naturally deposited in the rock.

Mr. Horrow: He testified what the rock was. The ore materials were taken from underground and deposited on the surface.

The Member: Any other questions?

Mr. Gallaher: Would you read the question?

The Member: I will overrule the objection.

Mr. Horrow: Exception.

The Member: Exception noted. [50]

(Testimony of Henry L. Slosson, Jr.)

(The question referred to was read by the reporter as above recorded.)

A. Yes, it is.

Cross-Examination

Q. (By Mr. Horrow): Mr. Slosson, I believe you stated that you were familiar with the property which is known as the American Flat property?

A. Yes, sir.

Q. Do you know the boundaries of that property?

A. Well, I know them in a general way. I know them particularly on the north; I am not so familiar on the south.

Q. Do you know the shafts that existed on that property at the time the so-called dumps were observed by you in 1907?

A. You mean the shafts on the Chollar property?

Q. I am speaking of the——

A. Or the general line of shafts along the Comstock?

Q. I am speaking of the mining shafts that were located on the property which has been referred to as the American Flat property.

A. There is one; I am familiar with that shaft, yes, sir.

Q. What was the name of that shaft?

A. The old Overman shaft.

Q. The Overman shaft?

A. The Overman shaft.

(Testimony of Henry L. Slosson, Jr.)

The Reporter: Spell it, please. [51]

The Witness: O-v-e-r-m-a-n.

Q. (By Mr. Horrow): Now, you referred to the Yellow Jacket. A. Yes, sir.

Q. Was that another shaft?

A. That was a shaft belonging to a mine that laid at the north—perhaps I can make it clear to you.

Q. Just let me ask the questions, Mr. Slosson. Then, maybe we can clear this thing up.

A. All right.

Q. Now, how far away was the Yellow Jacket Shaft from the dumps?

A. Well, the Yellow Jacket had 700 feet of ground; about 2000 feet.

Q. About how many feet?

A. About 2000 feet, between 1500 and 2000 feet.

Q. And is it your testimony that the ore materials which constituted the dumps came out of the Yellow Jacket?

A. The Yellow Jacket, the Crown Point, and the Belcher; there were three mines along there that produced ore.

Q. Just a moment. Some of them came out of the Yellow Jacket?

A. Out of the Yellow Jacket.

Q. Now, was there another mining shaft from which the ore materials were——

A. (Interposing): Hoisted? [52]

Q. (Continuing): Conveyed after they had been extracted from the earth?

(Testimony of Henry L. Slosson, Jr.)

A. From the mine, yes, sir. There was another shaft immediately south of the Yellow Jacket, the Kentuck.

Q. The Kentuck?

A. K-e-n-t-u-c-k.

Q. Now, how far away was that mining shaft from the dumps?

A. Well, that is about the same distance as the Yellow Jacket; the Kentuck was right next to the Jacket.

Q. And that Kentuck shaft is not located on the property known as the American Flat property?

A. No, sir.

Q. Now, was there any other shaft from which the ore materials were brought to the surface and placed in the dumps?

A. Yes, sir, there was the Crown Point.

Q. Now, what was the location of that shaft with respect to the location of the dumps?

A. That was just about a hundred feet away from the Kentuck, 200 feet away from the Kentuck.

Q. That shaft likewise was not on the American Flat property?

A. No; a long way from it. There was still another shaft, if you wish to know it.

Q. Now, you stated that at the time, in 1907, you were in charge of the Yellow Jacket?

A. Yes, I controlled it. [53]

Q. So that you were familiar with the property that was owned and used in connection with the Yellow Jacket?

(Testimony of Henry L. Slosson, Jr.)

A. Yes, sir, familiar with all that end of the lode.

Q. Now, was the land on which the dumps were located owned by you or by your corporation?

A. It was not owned; we had dumping privileges on it.

Q. Now, what do you mean "dumping privileges"?

A. Well, owing to the configuration of the ground near the Yellow Jacket—there was tremendous big ravines. The Crown Point shaft was right in the middle of the ravine. If we dumped the Yellow Jacket waste in the ravine we killed the Crown Point. The Crown Point had no dumping place, so all those gold mines many years before made some arrangement, the details of which I don't know, to have dumping ground to the south where we had area to spread it out.

Q. Who owned the American Flat property?

A. The Overman Mining Company.

The Member: May I interrupt just a moment to get some facts here? You say that if you would dump it down on the Crown Point it would kill the Crown Point. How would it kill it?

The Witness: Cover it up. The shaft was right in the middle of the ravine.

The Member: Oh, I see.

The Witness: Had they dumped in the ravine the Crown [54] Point would be down and out.

The Member: Yes, I see.

(Testimony of Henry L. Slosson, Jr.)

Q. (By Mr. Horrow): Now, Mr. Slosson, can you state whether any ore materials were conveyed to the surface through the Overman shaft and deposited in the dumps?

A. No; the Overman had a dump of its own right near the shaft.

Q. So the dumps that we are talking about didn't cover any ore materials that came out of the Overman shaft? A. No.

Q. And the Overman shaft was the only shaft that was located on the American Flat property?

A. The Overman shaft was the only shaft on the present Chollar ground.

Q. Well, now, you spoke of a dumping privilege. Did you have to pay for that privilege?

A. Well, that was way back in the '70s before I was born and I couldn't swear to it. All our records were destroyed in the fire in 1906. It would be a very difficult thing to prove.

Q. Well, in 1907 when you owned the Yellow Jacket did you consider that you owned the ore materials that came out of the Yellow Jacket and were in the dumps?

A. No, we didn't consider we owned them. We were trying to make a dicker with the Overman Mining Company at that time to see if we couldn't work them. [55]

Q. So that Overman, the owner of the American Flat property, was considered as the owner of the dumps?

A. Considered as the owner of the dumps but

(Testimony of Henry L. Slosson, Jr.)

the dumps were not produced by the Overman mine. They were just there.

Q. Yes. And Overman was considered the owner of the dumps because the ore materials were deposited on Overman's land pursuant to these privileges of dumping?

A. We figured we couldn't get these dumps off without consulting with somebody who owned the land.

Q. So your answer is "Yes", then, isn't it, Mr. Slosson? A. Yes, sir.

Q. Now, what was the method of conveying the ore materials from the head of the shaft to the dumps?

A. Which mine do you mean? The Yellow Jacket?

Q. From the Yellow Jacket? Take each mine.

A. We would hoist the rock through the Yellow Jacket shaft and run it through the bin, dumped it into a bin and then it was carried out on an iron car with an old mule, about a six-ton car.

Q. It was hauled by mules?

A. By mule way out to the end of that dump to get it out of the way.

Q. Now, was there any sorting process at the head of the shaft prior to the conveyance by mule to the dumps?

A. No, none whatever. [56]

Q. Well, wasn't the ore material assayed in order to determine its gold and silver content before you removed it to the dumps?

(Testimony of Henry L. Slosson, Jr.)

A. Oh, yes, assayed underground. The face of the drift is sampled.

Q. And do you know what methods were used to convey the ore materials from the head of the Kentuck and the——

A. (Interposing): Crown Point?

Q. Crown Point shaft?

A. Both those shafts were in a ruinous condition in 1907; nothing was being done to them at all.

Q. Well, do you know the methods that were used to convey ore materials from those mines over to the dumps on the American Flat?

A. Well, it was the same method; they ran out on the same track.

Q. It was the same method?

A. It was the same method exactly.

Q. Now, how did these dumps look in 1907? Would you describe them, just what——

A. (Interposing): Well, they were a very long pile of rock that ran there for, I should say, several hundred feet and the angle of repose, which is 35 degrees—the coarser rock was at the bottom, the finer rock at the top. The coarse rock rolls down; the dump goes to the bottom, as [57] a rule. For that reason in sampling a dump of that kind we would sample it half way up to try and get an average, which was very disappointing.

Q. It was simply piled up as waste material?

A. As waste; it was considered by people who piled it there as absolute waste.

(Testimony of Henry L. Slosson, Jr.)

Q. Now, the materials as they came out of the shaft were broken up by blasting, were they not?

A. They broke in the blast, yes. It was shovelable; you could shovel it. Otherwise, of course, you couldn't get it out.

Mr. Horrow: That is all.

Mr. Gallaher: That is all.

The Member: That is all.

(Witness excused.)

Mr. Gallaher: Mr. Barton.

THOMAS V. BARTON

a witness on behalf of Petitioner, was duly sworn and testified as follows:

The Clerk: Your full name, please, sir?

The Witness: Thomas V. Barton.

The Member: What is the last name?

The Witness: Barton, B-a-r-t-o-n.

Direct Examination

Q. (By Mr. Gallaher): Mr. Barton, what is your occupation? [58]

A. Mining engineer.

Q. Are you connected with the Petitioner, Consolidated Chollar Gould & Savage Mining Company?

A. As General Manager.

Q. And Vice President also?

(Testimony of Thomas V. Barton.)

A. Yes, sir.

Q. That company owns the lands on which the dumps are located that are involved in this matter, does it not? A. Yes, sir.

Q. Owns those lands in fee? A. In fee.

Q. Is it a fact that the Petitioner purchased those lands on which the dumps were located on July 1, 1933?

A. I think that is correct, about that time.

Mr. Gallaher: There is no question about that?

Mr. Horrow: There is no question about the date.

Q. (By Mr. Gallaher): Were these dumps in question on the land when it was purchased by the Petitioner? A. Yes, sir.

Q. Had they been processed to any extent whatever when the Petitioner purchased the land?

A. None whatever.

Q. Now, in 1936 and also in 1938 the Petitioner did process a portion of those dumps; is that so?

A. Yes. I just forgot exactly what year we started but I [59] would say '36.

Q. In '36 and again in 1938? A. Yes, sir.

Q. And as a result of processing the Petitioner made some profit? A. Yes, sir.

Q. Now, will you state whether or not there was any segregation made in the rock when it was placed upon that land as you found it when you bought it?

A. No, there was no segregation definitely. That

(Testimony of Thomas V. Barton.)

would be proved by the character in which we found it when we started digging into it.

Q. Will you describe what that character was?

A. Well, there were obvious layers of waste overlaying commercial ore. There was also waste underlaying certain sections of commercial ore. Had it been segregated the individual dumps would have shown it. Each layer was sort of a lamination starting from the top of the dump to its toes, as Mr. Slosson explained, the fines remaining on the higher parts of the dump. The laminations or the various periods were in very definite layers and one could almost indicate the extent of the material, the particular material by the width of those layers. You didn't recognize that until you started virtually cross-cutting in the conveying of these dumps to the mill, but there was very definite [60] evidence that they had never been removed, or never had been moved since they were originally placed there and there was no segregation.

Q. Where is the mill?

A. As to the dumps?

Q. Yes.

A. Oh, 2000 feet from the dumps southeast.

Q. The Petitioner operates its own mill, does it not? A. Pardon me?

Q. The Petitioner operates its own mill, does it not? A. Yes, sir.

Q. And what is the method used for processing the material constituting those dumps?

(Testimony of Thomas V. Barton.)

A. At the time we were handling the dumps, flotation.

Q. Will you describe to the Court what that method is, briefly.

A. Well, it is a method, your Honor, of crushing into required mesh when it is subjected to certain agents that have an affinity and then it is frothed and the froth reverses the laws of gravity by allowing the heavy particles to float over the top of the water and the gangue or lighter material sinking, and after the froth has come off—it is scraped off the top and then the bubbles have broken and the concentrate is shipped to the smelter. It is a cheaper process actually in the process itself but there *are* a lot of disadvan- [61] tages. The ratio of extraction is not very high and so ultimately we changed to cyanide which is a more efficient form of extraction.

The Member: How does that work, the cyanide treatment?

The Witness: Well, it is dissolving all values into solution and then precipitating, whereas, you make a concentrate in one you dissolve the values and precipitate and turn into bullion.

Q. (By Mr. Gallaher): I show you a picture, Mr. Barton, and ask you if you recognize that?

A. (Examining photograph): Yes, sir.

Q. What is that a picture of?

A. That is a picture of the Overman works, the Consolidated Chollar general mining here (indi-

(Testimony of Thomas V. Barton.)

cating), and the mill and the dumps in question over to the right. (Indicating).

Mr. Gallaher: We offer this in evidence.

Mr. Horrow: No objection. I would suggest, however, that there be some identification of it.

Mr. Gallaher: I was going——

Mr. Horrow (Interposing): Of the structures referred to.

Mr. Gallaher: I was going to do that after it was admitted.

Mr. Horrow: Yes, I have no objection.

The Member: Accepted in evidence. [62]

The Clerk: Exhibit 1.

(The photograph so offered and received in evidence, was marked Petitioner's Exhibit 1, and was made a part of this record.)

Q. (By Mr. Gallaher): Now, will you describe again what the various things are on that picture?

A. Well, over here on the extreme right (indicating) are the dumps.

Q. That is indicating a white spot about two inches from the right hand side of the picture and about the center vertically?

A. Yes, sir, and it is shown up to be of that color, because I think at the time this picture was taken we had removed quite a large portion of this dump. It isn't in its original form. If you notice, it looks a little jagged. We had already taken quite a large amount of it.

(Testimony of Thomas V. Barton.)

Over here (indicating) is the Overman shaft headframe.

Q. Indicating the building toward the left of the picture?

A. The furthest to the left is the mill. The white place over here (indicating) is the dump.

Q. Well, you mean——

A. (Interposing): I mean the tailings pond.

Q. The white place to the extreme left of the picture is what you term the tailings pond?

A. Tailings pond, yes. This is the dump here (indicating).

Mr. Horrow: This is the mill here (indicating)?

[63]

The Witness: The mill is here (indicating).

Q. (By Mr. Gallaher): Indicating the building farthest to the left. What is the large building in the center?

A. That is the office building.

Q. And the building farthest to the right is the Overman shaft?

A. No; the shaft is here (indicating), right behind the blacksmith shop, the machine shop.

The Member: Accepted in evidence.

Q. (By Mr. Gallaher): I show you three pictures and ask you if any of those three show the dumps as they were before you started to process them?

A. (Examining photographs): No, sir, none of these prior to processing.

(Testimony of Thomas V. Barton.)

Q. Which one is the earliest of the three, if you know?

A. Well, these are the dumps that we took (indicating). These are the dumps under discussion and you can tell by this appearance there that there has already been quite a large portion of them taken away. I don't think we have any dump pictures prior to our operations.

Mr. Horrow: I have no objection to using the one that shows the condition of the dumps at the point of time closest to the beginning of the processing.

Q. (By Mr. Gallaher): I believe that is this one, is it not?

A. What is that? I didn't understand that question. [64]

Q. The earliest picture.

A. (Examining photographs). I think they were all taken about the same time, only in different positions, because you see that dump (indicating) is practically the same as this (indicating) and it is just taken in a different position because these dumps here (indicating) are what these dumps are on, and, I think, consequently are taken the same time.

Mr. Gallaher: I offer these three pictures in evidence.

The Member: No objection?

Mr. Horrow: I have no objection except I suggest they be identified so your Honor can make use of them.

(Testimony of Thomas V. Barton.)

The Member: As I gathered from the witness there is not much difference between the three, is there?

Mr. Horrow: I see.

Mr. Gallaher: No, not much, not much. I don't insist upon placing them in evidence. I thought they might be of some assistance to the Court.

Mr. Horrow: I have no objection just so long as——

The Member (Interposing): All right, they will be admitted as Petitioner's Exhibits 2, 3, and 4.

(The three photographs, so offered and received in evidence, were marked Petitioner's Exhibits 2, 3, and 4, and were made a part of this record.)

The Member: Is this property as shown in Petitioner's [65] Exhibit No. 1, Mr. Witness, near the road from Virginia City to Reno?

The Witness: To Carson, your Honor. This is down the—if you know the district, this is below Virginia City, Gold Hill, on the way down towards Carson and Silver City.

The Member: I see.

The Witness: It is half way between Silver City and the Divide.

The Member: Oh!

The Witness: And that would put the road just east of about where your thumb is on this side, you see. You can't see the road, but it is very close to the bottom of the picture.

(Testimony of Thomas V. Barton.)

The Member: Off the record.

(Discussion outside the record.)

The Member: All right, counsel.

Mr. Gallaher: That is all.

Cross-Examination

Q. (By Mr. Horrow): Mr. Barton, will you state the method that was used in removing the ore materials from the dumps to the mill?

A. The what?

Q. The method that was used in removing the ore materials from the dumps to the mill for processing. [66]

A. Power shovel.

Mr. Gallaher: What time?

The Witness: And truck.

Mr. Gallaher: Pardon me, and what time is this, counsel?

Mr. Horrow: As at the time the Petitioner first removed ore materials from the dumps.

The Witness: That is the only way we did it at any time.

Q. (By Mr. Horrow): What was that method, Mr. Barton?

A. With a power shovel and trucks. The question was how did they convey the material from the dumps to the mill?

Q. That is right.

The Member: That is right.

A. Yes, sir.

Q. (By Mr. Horrow): The ore materials were

(Testimony of Thomas V. Barton.)

scooped up by the shovels and dumped into the trucks and conveyed to the mill; is that correct?

A. Yes, sir.

Q. Now, when was that mill erected?

A. Well, we have made four changes, and I couldn't be definite, but I think in '34 or '35.

Q. The mill was erected after the dumps had been acquired by Petitioner, is that correct?

A. Oh, no; we acquired the property in '33. The mill was built in '34 or '5; I wouldn't be sure. We started with a little 50-ton mill and now we have a 500 and have made so [67] many changes I really forget the actual dates but we did not start milling off the dumps immediately. We had other ore bodies at that time that contained more value. It was not until later when the price of gold jumped 70 per cent we were able to make this of commercial value.

Mr. Morrow: That is all, your Honor.

Mr. Gallaher: That is all.

The Member: That is all, Mr. Barton.

(Witness excused.)

Mr. Gallaher: May I recall Mr. Slosson for one further question?

The Member: Yes, sir.

HENRY L. SLOSSON, JR.

a witness recalled on behalf of Petitioner, having

(Testimony of Henry L. Slosson, Jr.)
been previously duly sworn, testified further as follows:

Redirect Examination

Q. (By Mr. Gallaher): Mr. Slosson, do you know whether or not any of the material constituting the dumps was placed in its present position after 1913?

A. Oh, no, none of it. Those mines were all shut down.

Mr. Gallaher: That is all.

Mr. Horrow: I have no further questions.

The Member: That is all, Mr. Slosson.

(Witness excused.) [68]

The Member: Does Petitioner have further testimony?

Mr. Gallaher: May I be pardoned for a moment?

The Member: Yes, sir.

Mr. Gallaher: May I have the indulgence of the Court to recall Mr. Barton for one question?

The Member: Yes.

THOMAS V. BARTON

a witness recalled on behalf of Petitioner, having been previously duly sworn, testified further as follows:

Redirect Examination

Q. (By Mr. Gallaher): Mr. Barton, when the Petitioner purchased the property on which the

(Testimony of Thomas V. Barton.)

dumps were located was the ore in the rock, in its natural condition in the rock?

Mr. Horrow: Same objection as previously noted, your Honor.

A. Surely.

The Member: I don't——

Mr. Horrow (Interposing): I think it is argumentative.

The Member: Well, I mean I think it is almost to be taken for granted. Your question is whether or not these dumps were composed of rock that had never been processed. Isn't that, in effect, your question?

Mr. Gallaher: Yes, and to bring out that the metal is naturally deposited in the rock just as it was originally, [69] except the rock itself has been moved from one point to another.

The Member: Well, the only alternative to that would be that the metal got into the rock by some artificial way which I don't consider to be feasible.

Mr. Gallaher: I thought that was clear myself, if your Honor please. That is all.

The Member: Any other questions?

Mr. Horrow: I have nothing further.

The Member: I will overrule this objection so the witness can answer.

Have you answered the question?

The Witness: I don't know, sir.

The Member: Read the question to the witness.

Mr. Horrow: Exception.

(Testimony of Thomas V. Barton.)

The Member: Exception granted.

(The question referred to was read by the reporter as above recorded.)

A. Certainly.

The Member: Any other questions?

Mr. Horrow: Just one question.

Recross Examination

Q. (By Mr. Horrow): How high would you say was the highest point on the dumps?

A. Vertical height to the top of the dumps? [70]

Q. Yes.

A. Well, I am guessing to a certain extent but I would say 60 to 80 feet.

Q. So that, in your opinion as a mining engineer, if materials were taken from three different mining shafts and deposited in the same place the effect of depositing these materials on top of each other would cause a cohesive effect upon those materials so that they would all be pushed together?

A. Not exactly.

Q. Well, what would be the effect of depositing ore materials on top of materials that had been previously deposited on the surface?

A. Unless the particular materials carried chemicals that would have an altering effect on it there would be no change whatever.

Q. Well, now, you are familiar with the condition of ore material as it comes from the shaft of the mine upon blasting? A. Yes, sir.

Q. Would you say that the ore materials that

(Testimony of Thomas V. Barton.)

were in these dumps were in the same condition as they were when they came from the head of the shaft after having been blasted?

A. No doubt about it.

Q. So that if the materials came out of the mine in fragments because of blasting those fragments were still in exactly the same physical state after having been deposited and other [71] materials deposited on top of those materials?

A. Exactly the same except where they, probably through bouncing down the dump they may have reduced themselves in size, the larger portions; otherwise, they were the same.

Q. In your opinion as a mining expert would the debris or the ore materials resulting from the blasting commingle with other such materials upon being deposited together?

A. Not to any great extent, sir. The idea, as I told you at the first, was they more or less stay in the layers, that is, if there are any quantities that come out of each section.

Q. Well, now, Mr. Barton, when the ore materials were removed by the power shovel from the dumps were any blasting operations necessary to facilitate the removal of the ore materials from the dumps?

A. No, sir, with the exception that sometimes when the bank got a little too steep for the shovel to handle there would be a pipe driven down and a

(Testimony of Thomas V. Barton.)

few sticks of powder just to shake the top down so it wouldn't cover the shovel up.

Mr. Horrow: That is all, your Honor.

Redirect Examination

Q. (By Mr. Gallaher): Mr. Barton, do you know what the type of rock is that constitutes the dumps? A. The what?

Q. The type of rock? [72]

A. Well, the type that we were interested in was the quartz.

Q. Quartz is very hard, is it not?

A. It was the harder, yes, but had been in its native state subjected to a shattering. The general condition of the dumps was not known as what would be termed a coarse dump. There was a large percentage of it quite fine, which is the condition as it is handled underground all along that section of the lode.

Mr. Gallaher: That is all.

Mr. Horrow: No further questions.

The Member: That is all, Mr. Barton.

(Witness excused.)

Mr. Gallaher: We are prepared, if your Honor please, to stipulate as to the figures.

May I suggest that we reduce the stipulation to writing and file it in the record at a later time? We weren't prepared to do that before we arrived here today.

The Member: Well, you can dictate it into the

record if you would care to. Suppose then we take a recess at this time and you can consult together with regard to the stipulation.

Mr. Horrow: I can say, your Honor, we are in agreement with the figures. I can read them into the record and Mr. Cummings, the accountant can check them.

The Member: Suppose we take a recess. [73]

Mr. Horrow: Very well, your Honor.

(Whereupon a short recess was taken after which the proceedings were resumed as follows:)

Mr. Horrow: If your Honor please, we are prepared to stipulate the figures as to the taxable income of Petitioner for the years '36 and '38 and the source of the income.

We will stipulate that the net income before depletion for 1936 is $22,610.70, that income was derived by Petitioner during that year from the milling of dump ores, which are the dump ores in question, and in respect of which percentage depreciation is claimed, the amount of said income being $71,211.40, that Petitioner sustained a loss from mining operations, that is, operations in connection with the extracting of ores from underneath the surface and the milling of said ores, said loss being in the amount of $53,397.29. Further that Petitioner for 1936 realized a profit from the ores which Petitioner purchased from other persons in the amount of $4,796.58. The latter amount is not income in

respect of which Petitioner is claiming a deduction for percentage depletion.

I might say that these are the figures that are set forth in the deficiency notice for 1936.

For the year 1938 Petitioner's taxable net income before depletion is $9,425.25, that Petitioner realized income from mining operations, that is, the extraction of [74] ores from underneath the surface and the processing of said ores, said profit being in the amount of $2,343.19.

The Respondent will stipulate that that income is subject to percentage depletion.

The income from the processing of ores from the dumps in question and in respect of which Petitioner is claiming an allowance for percentage depletion for the year 1938 was $2,924.12. Petitioner realized income from the processing of ore purchased from other persons in the amount of $3,-792.18. Said income is not income in respect of which percentage depletion is being claimed.

Petitioner also realized for 1938 other income such as interest and similar income in the amount of $365.76 and said income is likewise not income in respect of which percentage depletion is being claimed.

Is that stipulation satisfactory?

Mr. Gallaher: That stipulation is satisfactory.

The Member: Anything else, gentlemen?

Mr. Gallaher: That is all, if your Honor please. The Petitioner rests.

Mr. Horrow: Respondent rests.

The Member: Briefs to be filed within 45 days, and reply briefs within 30 days thereafter.

Thank you, gentlemen.

(Hearing concluded.)

[Endorsed]: U. S. B. T. A. Filed July 14, 1941.

[75]

[Title of Board and Cause.]

FINDINGS OF FACT AND OPINION

Docket Nos. 104195, 105095. Promulgated February 4, 1942.

Petitioner acquired property in Nevada upon which were "dumps" composed of broken ore-bearing rock taken from mines located on adjacent property. At the time the "dumps" were placed on petitioner's property they were considered worthless. As a result of improvements in extracting methods the contents of these dumps were milled by petitioner at a profit. Held, these "dumps" are not mines and petitioner is not entitled to percentage depletion under sections 23 (m) and 114 (b) (4) of the Acts of 1936 and 1938. Atlas Milling Co. v. Jones, 115 Fed. (2d) 61, followed; Kennedy Mining & Milling Co., 43 B. T. A. 617, distinguished.

John D. Gallaher, Esq., and William A. Boekel, Esq., for the petitioner.

Harry R. Horrow, Esq., for the respondent.

These proceedings, consolidated for hearing and decision, involve deficiencies determined by respond-

ent in petitioner's income tax for the years 1936 and 1938 in the respective amounts of $3,625.45 and $676.59: The petitions herein put at issue that part of the deficiencies which arises by reason of respondent's refusal to allow petitioner percentage depletion under the provisions of section 114 (b) (4) of the Revenue Acts of 1936 and 1938,[1] with respect to income derived by petitioner from the extraction of ores from "dumps" composed of broken rock taken from mines adjacent to petitioner's property. [76]

FINDINGS OF FACT

The petitioner is a corporation organized under the laws of the State of California, with its principal office at San Francisco, California. It filed its in-

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[1] Sec. 114. Basis for Depreciation and Depletion.

* * * * * * *

(b) Basis for Depletion.—

* * * * * * *

(4) Percentage Depletion for Coal and Metal Mines and Sulphur.—The allowance for depletion under section 23 (m) shall be, in the case of coal mines, 5 per centum, in the case of metal mines, 15 per centum, and, in the case of Sulphur mines or deposits, 23 per centum, of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property. * * *

come tax returns for the calendar years 1936 and 1938 with the collector of internal revenue for the first district of California. On or about July 1, 1933, petitioner acquired by purchase from the Bullion Gold & Silver Mining Co. property known as the American Flat property, located near Virginia City, Nevada. At all times during the years 1936 and 1938 petitioner was the owner in fee of said property.

On its income tax returns the petitioner elected to have its depletion allowance computed on the basis of percentage depletion. During the year 1936 the petitioner derived income from the processing of certain dump ores, located on the American Flat property, known as the Yellow Jacket and Belcher dumps, in the amount of $71,211.40. In arriving at the deficiency involved for the year 1936, the respondent did not include this amount in depletion net income for purposes of computing percentage depletion under section 114 (b) (4) of the Revenue Act of 1936. During the year 1938 petitioner realized income from the processing of ores in these dumps in the amount of $2,924.12. Respondent did not allow petitioner any deduction for percentage depletion for said year.

The dumps, referred to above, were created during the period between 1872 and 1898. None of the ore materials in these dumps had ever been milled, nor had any attempt been made prior to their purchase by petitioner to extract any minerals from them. At the time they were created, there were no mills for processing located on the American Flat property.

The ore materials constituting these dumps could not have been milled at a profit at the time they were deposited in the dumps.

On the American Flat property there is located only one shaft for the conduct of mining operations, known as the Overman shaft. However, on property adjacent to the American Flat property, there were located shafts known as the Yellow Jacket, Crown Point, Kentuck, and Belcher. None of these shafts was located on the property purchased by petitioner. All of the ore materials in the dumps in question were extracted from the mines known as Yellow Jacket, Kentuck, Crown Point, and Belcher. The owners of these mines had the privilege of dumping their waste ore materials extracted from their mines on the American Flat property. The American Flat property prior to 1907 was owned by the Overman Mining Co. None of the ore materials from the Overman shaft were placed in the dumps in question. This company had a separate dump of its own near its own shaft, but at the time the ore materials from the other mines [77] were dumped on this property, it was considered that the Overman Mining Co. thereby became the owner of these materials.

These materials were extracted from the mines referred to by blasting. They were then hoisted to the top of the shafts and dumped into bins, and then carried out to the dumps on iron cars drawn by mules.

In 1907 the dumps were several hundred feet high, with the coarser rock at the bottom and the finer ore

materials at the top. As a rule, the coarse rock rolled down to the bottom of the dump leaving the finer materials on top. When petitioner began removing the ore materials in the dumps, it was discovered that there was no segregation of the waste ore materials and the commercial ore materials. There were various layers in the dumps, however, which showed that the finer ore materials remained on the higher part of the dumps.

Petitioner erected a mill in 1934 about 2,000 feet from the dumps. At first it used the flotation process for removing the mineral content in the ore materials constituting the dumps. Thereafter, the petitioner resorted to the cyanide process for this purpose. The ore materials were removed from the dumps to the mill for processing by use of a power shovel. They were then dumped into trucks, which conveyed the materials to the mill.

The dumps in question did not constitute a mine, and none of the income derived by petitioner from the processing of ore materials located in the dumps during the years 1936 and 1938 constituted income from a mine for purposes of percentage depletion under the provisions of section 114 (b) (4) of the Revenue Acts of 1936 and 1938.

OPINION

Kern: The question which is here presented for decision is whether the "dumps" which were deposited upon petitioner's premises from adjacent mines and from which ore was extracted can be con-

sidered as a mine within the meaning of section 114 (b) (4), set out above, and section 23 (m),[2] which sections appear as quoted in the Revenue Acts for both 1936 and 1938. [78]

In Atlas Milling Co. v. Jones, 115 Fed. (2d) 61 (certiorari denied, 312 U. S. 686), the taxpayer, pursuant to its rights under a lease contract, went

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[2] Sec. 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

* * * * * * *

(m) Depletion.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. For percentage depletion allowable under this subsection, see section 114 (b), (3) and (4).

upon certain lands and removed crushed rock which constituted the residue from mining and milling operations carried on by the owners of the premises. By reason of a new extraction process it had become profitable to remill and retreat such "tailings" or residue. This the taxpayer did. It was held that taxpayer was not entitled to percentage depletion. In its opinion the court said in part:

A "mine" is an excavation in the earth from which ores, coal, or other mineral substances are removed by digging or other mining methods. In its broader sense it denotes the vein, lode, or deposit of minerals. Mining connotes the removal of minerals from a natural deposit. It does not embrace the reworking of mineral dumps artificially deposited from the residue remaining after the ore has been milled and concentrates removed therefrom. So. Utah Mines & Smelters v. Beaver County, 262 U. S. 325, 332. In the case last cited the court said:

> The tailings severed and removed from the mining claims, changed in character, placed on other and separate lands and having an ascertained and adjudicated value of their own, in our opinion, constituted a unit of property entirely apart from the mine from which they had been taken. See Forbes v. Gracey, 94 U. S. 762, 765.

Ores when severed from their natural deposit become personal property. Trover and conversion will lie for their wrongful taking.

While tailings deposited on the surface of land may become appurtenant to the land, they in no true sense become a mine.

We are of the opinion that the word "mines" as used in, § 23, supra, is limited to natural deposits and does not include a tailings dump deposited on the surface of land, consisting of the residue of ore that has been severed and milled.

* * * * * * *

* * * Here, Atlas (the taxpayer) owns no economic interest in the mine from which the minerals were severed. To entitle it to depletion we would have to hold that the tailings, not a natural deposit but ore-bearing rock artificially deposited on the surface of the ground, constitutes a mine within the meaning of § 23, supra. We are of the opinion that it may not be so regarded. * * *

Petitioner here seeks to distinguish this proceeding from that case. It argues that there the court had before it a problem having to do with "tailings" made up of the residue of rock left after it had once been milled, whereas here the dumps were made up of broken rock which had never been milled and within which the ore was still deposited. [79]

We consider this difference to be immaterial. The dumps of petitioner were of "ore-bearing rock artificially deposited on the surface of the ground", and the petitioner had no economic interest in the mines from which such rock was severed. These are the determinative facts which bring this proceeding

within the reasoning of Atlas Milling Co. v. Jones, supra. See also Carl M. Britt, 43 B. T. A. 254.

The distinction between this proceeding and Kennedy Mining & Milling Co., 43 B. T. A. 617, is obvious. In that case the "tailings" were from ore-bearing rock severed from mines owned and operated by the taxpayer. Under those circumstances, we said:

* * * The economic interest of this petitioner in the tailings and in the minerals to be extracted therefrom was identical with the interest it had maintained through its ownership of the mine from beginning to end of the extractive process; and when it finally received the proceeds of the minerals contained in the tailings it received income from the contents of the mine to exactly the same extent as the income it had previously received from the earlier and more rudimentary refining process. * * *

Deductions for depletion are matters of legislative grace, Ozark Chemical Co. v. Jones, — Fed. (2d) —(C. C. A., 10th Cir., Dec. 23, 1941), and none more so than deductions on account of percentage depletion. Since the petitioner has not brought itself clearly within the act, he can not claim the deduction sought.

At the hearing herein the parties entered into certain stipulations with regard to petitioner's income for the years in question to which consideration shall be given by counsel in preparing recomputations of petitioner's tax liability in accordance with this opinion.

Decision will be entered pursuant to Rule 50. [80]

United States Board of Tax Appeals
Washington

Docket No. 104195

CONSOLIDATED CHOLLAR GOULD & SAVAGE MINING COMPANY, a corporation,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the findings of fact and opinion of the Board promulgated February 4, 1942, the respondent herein on March 4, 1942 having filed a recomputation of tax and the petitioner on March 23, 1942 having filed an agreement to such recomputation, now, therefore, it is

Ordered and Decided: That there is a deficiency in income tax for the calendar year 1936 in the amount of $3,625.45.

(Signed) C. R. ARUNDELL
Member

Enter:

Entered Mar. 25, 1942. [81]

United States Board of Tax Appeals
Washington

Docket No. 105095

CONSOLIDATED CHOLLAR GOULD & SAVAGE MINING COMPANY, a corporation,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the findings of fact and opinion of the Board promulgated February 4, 1942, the respondent herein on March 4, 1942 having filed a recomputation of tax and the petitioner on March 23, 1942 having filed an agreement to such recomputation, now, therefore, it is

Ordered and Decided: That there is a deficiency in income tax for the calendar year 1938 in the amount of $512.57.

(Signed) C. R. ARUNDELL
Member

Enter:

Entered Mar. 25, 1942. [82]

In the United States Circuit Court of Appeals
For the Ninth Circuit

B. T. A. Docket Nos. 104195 and 105095

CONSOLIDATED CHOLLAR GOULD & SAVAGE MINING COMPANY,
Petitioner on Review,

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,
Respondent on Review.

PETITION FOR REVIEW AND STATEMENT OF POINTS

To the Honorable Judges of the United States Circuit Court of Appeals for the Ninth Circuit:

Now Comes Consolidated Chollar Gould & Savage Mining Company, a corporation, by its attorneys, William A. Boekel and John D. Gallaher, and respectfully shows:

I.

JURISDICTION

The petitioner on review (hereinafter referred to as the taxpayer) is a corporation organized and existing under the laws of the State of California, having its principal office in the Kohl Building, San Francisco, California. [83]

The respondent on review, Guy T. Helvering, is the duly appointed, qualified and acting Commis-

sioner of Internal Revenue of the United States.

The taxpayer filed its Federal income tax returns for the taxable years 1936 and 1938 with the Collector of Internal Revenue for the First District of California, whose office is located in the City and County of San Francisco, State of California, and within the judicial circuit of the United States Circuit Court of Appeals for the Ninth Circuit.

The taxpayer files this petition pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

II.

PRIOR PROCEEDINGS

On May 14, 1940 the Commissioner of Internal Revenue determined a deficiency in Federal income taxes against the taxpayer for the year 1936 in the amount of $3,625.45 and on the same date mailed a notice to the taxpayer notifying the taxpayer of such determination. On July 11, 1940 the Commissioner of Internal Revenue determined a deficiency in Federal income taxes against the taxpayer for the year 1938 in the amount of $655.45 and on the same date mailed to the taxpayer a notice of such determination. Within ninety days after the mailing of said notices respectively, the taxpayer filed appeals from said determinations of the Commissioner with the United States Board of Tax Appeals, Docket Nos. 104195 [84] and 105095.

The appeals were consolidated for hearing and decision and were duly tried and submitted to the

United States Board of Tax Appeals and under date of February 4, 1942, the Board promulgated its findings of fact and opinion (46 B. T. A. No. 34), pursuant to which opinion decisions were entered by the Board on March 25, 1942 wherein and whereby it was ordered and decided that there was a deficiency in income tax for the calendar year 1936 in the amount of $3,625.45 and a deficiency in income tax for the calendar year 1938 in the amount of $512.57.

III.

NATURE OF CONTROVERSY

The taxpayer is a mining corporation organized and existing under the laws of the State of California. On or about July 1, 1933 the taxpayer acquired by purchase from the Bullion Gold and Silver Mining Company, mining property known as the American Flat property, located near Virginia City, Nevada. At all times during the years 1936 and 1938 the taxpayer was the owner in fee of said property.

During the years 1936 and 1938 the taxpayer derived income from processing certain dumps located upon the American Flat property known as the "Yellow Jacket" and "Belcher" dumps. The rock and material constituting these so-called dumps had been removed from mines adjacent to the American Flat property and had been placed upon the American Flat [85] property during the period between 1872 and 1898. Such material had never been

processed and no attempt had ever been made to extract precious metals therefrom until the taxpayer commenced processing the same in the year 1936. The dumps were on the American Flat property acquired by the taxpayer at the time of the acquisition thereof and were owned by the taxpayer during the years 1936 and 1938.

The taxpayer filed its first income tax return for the calendar year 1933 and elected at the time of making said return to have the depletion allowance for its mining property for the taxable year 1934 and subsequent taxable years computed with regard to percentage depletion under the provisions of Section 114 (b) (4) of the Revenue Act of 1932, and again elected at the time of filing its return for the year 1934 to have the depletion allowance for the taxable year 1934 and subsequent taxable years computed with regard to said percentage depletion under the provisions of Section 114 (b) (4) of the Revenue Act of 1934. The taxpayer, in its income tax returns for the years 1936 and 1938 deducted percentage depletion upon its income from processing the ore materials constituting said dumps. The commissioner disallowed the deductions insofar as they were based upon such income. The Board of Tax Appeals was of the opinion that said dumps did not constitute a mine and that percentage depletion was therefore not allowable under the provisions of Section 114 (b) (4) of the Revenue Acts of 1936 and 1938. [86]

IV.

STATEMENT OF POINTS

Following is a concise statement of the points upon which the taxpayer intends to rely on the review herein petitioned, to-wit:

The United States Board of Tax Appeals erred:

1. In failing to hold that the ores and precious metals were naturally deposited in the dumps in question and that the same constituted a part of the taxpayer's mine within the meaning of Section 114 (b) (4) of the Revenue Acts of 1936 and 1938.

2. In holding that percentage depletion under said section of said acts is not allowable with respect to income derived from processing said dumps.

3. In holding that there were deficiencies in the income tax returns of the taxpayer for the years 1936 and 1938 by reason of the disallowance of the percentage depletion claimed by the taxpayer for those years.

4. In that its opinion and decision are contrary to its findings of fact.

5. In that its opinion and decision are not supported by its findings of fact and are contrary to law.

Wherefore, the taxpayer petitions that the decision of the United States Board of Tax Appeals be reviewed by the United States Circuit Court of Appeals for the Ninth [87] Circuit, that a transcript of the record be prepared in accordance with law and with the rules of said Court and transmitted to

the Clerk of said Court for filing, and that appropriate action be taken to the end that the errors complained of may be reviewed and corrected by said Court.

WILLIAM A. BOEKEL
JOHN D. GALLAHER
Attorneys for Petitioner
on Review
604 Federal Reserve Bank
Building,
San Francisco, California.

[Endorsed]: U. S. B. T. A. Filed June 24, 1942.

[88]

[Title of Board and Cause—Dockets Nos. 104195, 105095.]

NOTICE OF FILING PETITION FOR REVIEW AND STATEMENT OF POINTS

To the General Counsel of the Bureau of Internal Revenue, Washington, D. C.

You are hereby notified that Consolidated Chollar Gould & Savage Mining Company did, on the 24th day of June, 1942, file with the Clerk of the United States Board of Tax Appeals at Washington, D. C. a petition for review by the United States Circuit Court of Appeals for the Ninth Circuit of the decision of the Board heretofore rendered in the above entitled cases and a statement of points. A copy of

the petition for review and the statement of points as filed is hereto attached and [89] served upon you.

Dated this 24th day of June, 1942.

WILLIAM A. BOEKEL
JOHN D. GALLAHER
Attorneys for Petitioner
on Review.

Personal service of the above and foregoing notice, together with a copy of the petition for review and statement of points mentioned therein is hereby admitted this 24th day of June, 1942.

(s) J. P. WENCHEL
C. S. R.
Chief Counsel
Bureau of Internal Revenue

[Endorsed]: U.S.B.T.A.Filed June 24, 1942. [90]

[Title of Board and Cause—Dockets Nos. 104195, 105095.]

DESIGNATION OF CONTENTS OF RECORD ON REVIEW

To the Clerk of the United States Board of Tax Appeals:

Now Comes Consolidated Chollar Gould & Savage Mining Company, a corporation, the petitioner on review herein, by and through its attorneys, William A. Boekel and John D. Gallaher, and for the purpose of the review which it, the said petitioner on review has heretofore taken to the United States Circuit

Court of Appeals for the Ninth Circuit, hereby designates for inclusion in the record on review the following in the above numbered cases, Docket Nos. 104195 and 105095: [91]

1. Docket entries of the proceedings before the Board in each case.
2. Pleadings before the Board in each case:
   (a) Petition, including exhibits attached thereto.
   (b) Answer.
3. The entire record of the proceedings before the Board at San Francisco, California on June 27, 1941, as contained in the phonographic reporter's transcript of such proceedings, including the exhibits. In this connection for the purposes of convenience, petitioner on review respectfully suggests that pursuant to Rule 75 (i) of the Rules of Civil Procedure for the District Courts of the United States, Exhibits Nos. P-1, P-2, P-3 and P-4 be sent to the Appellate Court in lieu of copies.
4. Findings of fact and Opinion of the Board promulgated February 4, 1942.
5. Decision entered March 25, 1942, in each case.
6. Petition for review and statement of points.
7. Notice of filing petition for review.
8. This designation of contents of record on review.

Wherefore, it is requested that copies of the rec-

ord as above designated be prepared and transmitted to the United States Circuit Court of Appeals for the Ninth Circuit, in accordance with the rules of said Court.

WILLIAM A. BOEKEL
JOHN D. GALLAHER
Attorneys for Petitioner
on Review. [92]

Personal service of the above and foregoing Designation of Contents of Record on Review is hereby acknowledged this 24th day of June, 1942.

(s) J. P. WENCHEL
(Illegible initial)
Chief Counsel Bureau of
Internal Revenue.

[Endorsed]: U. S. B. T. A. Filed June 24, 1942. [93]

[Title of Board and Cause — Docket Nos. 104195, 105095.]

CERTIFICATE OF CLERK

I, B. D. Gamble, clerk of the U. S. Board of Tax Appeals, do hereby certify that the foregoing pages, 1 to 93, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Praecipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of the United States Board of Tax

Appeals, at Washington, in the District of Columbia, this 7th day of July, 1942.

[Seal] B. D. GAMBLE
Clerk, United States Board of Tax Appeals.

[Endorsed]: No. 10198. United States Circuit Court of Appeals for the Ninth Circuit. Consolidated Chollar Gould & Savage Mining Company, a Corporation, Petitioner, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Upon Petition to Review a Decision of the United States Board of Tax Appeals.

Filed July 21, 1942.

PAUL P. O'BRIEN
Clerk of the United States Circuit Court of Appeals for the Ninth Circuit.

In the United States Circuit Court of Appeals
For the Ninth Circuit

B. T. A. Docket Nos. 104195 and 105095.

CONSOLIDATED CHOLLAR GOULD & SAVAGE MINING COMPANY,
Petitioner on Review,

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,
Respondent on Review.

STATEMENT OF POINTS ON WHICH APPELLANT INTENDS TO RELY AND DESIGNATION OF RECORD.

To the Clerk of the United States Circuit Court of Appeals for the Ninth Circuit:

Now Comes Consolidated Chollar Gould & Savage Mining Company, a corporation, the petitioner on review herein, and designates for printing the entire transcript as certified by the Clerk of the Board of Tax Appeals and adopts as the points on which it intends to rely on appeal the statement of the points appearing in said transcript.

Dated: This 30th day of July, 1942.

WILLIAM A. BOEKEL,
JOHN D. GALLAHER,
Attorneys for Petitioner
on Review.

Service and receipt of a copy of the foregoing is hereby admitted this 1st day of August, 1942.

J. P. WENCHEL,
Chief Counsel Bureau of
Internal Revenue.

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No. 10,198

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

CONSOLIDATED CHOLLAR GOULD & SAVAGE MINING COMPANY (a corporation),
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for Review of Decision of the United States Board of Tax Appeals.

BRIEF FOR PETITIONER.

WILLIAM A. BOEKEL,
JOHN D. GALLAHER,
111 Sutter Street, San Francisco,
Attorneys for Petitioner.

PERNAU-WALSH PRINTING CO., SAN FRANCISCO

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No. 10,198

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

CONSOLIDATED CHOLLAR GOULD & SAVAGE MINING COMPANY (a corporation),
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for Review of Decision of the United States Board of Tax Appeals.

BRIEF FOR PETITIONER.

OPINION BELOW.

The opinion of the United States Board of Tax Appeals (R. 72-79) is reported in 46 B.T.A.—No. 34.

JURISDICTION.

The petition for review in this case involves asserted deficiencies in income taxes for the years 1936 and 1938 and is taken from decisions of the Board of Tax Appeals entered March 25, 1942. (R. 80-81.) The petition for review was filed June 24, 1942 (R. 82-87), pursuant to the provisions of Sections 1141-1142 of the Internal Revenue Code.

QUESTIONS PRESENTED.

Whether the petitioner is entitled to deduct, under Section 23 (m) of the Revenue Act of 1934 and the same section of the Revenue Act of 1936, percentage depletion in respect to income derived during the tax years 1936 and 1938 from the extraction of gold by the petitioner from certain dumps consisting of rocks and ore material which had never been milled or processed in any way but which had been deposited upon lands owned by the petitioner many years prior to the acquisition of said lands by the petitioner.

STATUTES AND REGULATIONS INVOLVED.

Revenue Act of 1934, c. 277, 48 Stat. 680:

Sec. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * * (U.S.C., Title 26, Sec. 23.)

Sec. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * * * *

(b) *Basis for depletion.*

* * * * * * *

(4) *Percentage depletion for coal and metal mines and sulphur.*—The allowance for depletion under section 23 (m) shall be, in the case of coal mines, 5 per centum, in the case of metal mines, 15 per centum, and, in the case of sulphur mines or deposits, 23 per centum, of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property. A taxpayer making his first return under this title in respect of a property shall state whether he elects to have the depletion allowance for such property for the taxable year for which the return is made computed with or without regard to percentage depletion, and the depletion allowance in respect of such property for such year shall be computed according to the election thus made. If the taxpayer fails to make such statement in the return, the depletion allowance for such property for such year shall be computed without reference to percentage depletion. * * * (U.S.C., Title 26, Sec. 114.)

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

Art. 23 (m)-1. *Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.*—* * *

* * * * * * *

(b) A "mineral property" is the mineral deposit, the development and plant necessary for its extraction, and so much of the surface of the land only as is necessary for purposes of mineral

extraction. The value of a mineral property is the combined value of its component parts.

* * * * * * *

(g) "Gross income from the property" as used in section 114 (b) (3) and (4) and articles 23 (m)-1 to 23 (m)-28, inclusive, means the amount for which the taxpayer sells (a) the crude mineral product of the property or (b) the product derived therefrom, not to exceed in the case of (a) the representative market or field price (as of the date of sale) of crude mineral product of like kind and grade before transportation from the immediate vicinity of the mine or well, or in the case of (b) the representative market or field price (as of the date of sale) of a product of the kind and grade from which the product sold was derived, before the application of any processes (to which the crude mineral product may have been subjected after emerging from the mine or well) with the exception of those listed below, and before transportation from the place where the last of the processes listed below was applied. * * *

* * * * * * *

(4) In the case of lead, zinc, copper, gold, or silver ores and ores which are not customarily sold in the form of the crude mineral product—crushing, concentrating (by gravity or flotation), and other processes to the extent to which they do not beneficiate the product in greater degree (in relation to the crude mineral product on the one hand and the refined product on the other) than crushing and concentrating (by gravity or flotation).

STATEMENT.

The petitioner is a corporation organized under the laws of the State of California with its principal office at San Francisco, California. It filed its income tax returns for the calendar years 1936 and 1938 with the Collector of Internal Revenue for the First District of California. On its income tax returns, the petitioner elected to have its depletion allowance computed on the basis of a percentage depletion. During the year 1936 the petitioner derived income in the amount of $71,211.40 from the processing of certain dumps known as the Yellow Jacket and Belcher Dumps, located on property known as the American Flat property near Virginia City, Nevada. During the year 1938, the petitioner realized income from the processing of ores in these dumps in the amount of $2924.12. (R. 73.) It was stipulated that petitioner's net income, before depletion, from this source for 1936 was $22,610.70, and that the net income, before depletion, from this source for the year 1938 was $2924.12. (R. 69-70.) The petitioner in computing its tax upon its returns claimed percentage depletion in accordance with its election with respect to said income. The respondent disallowed the percentage depletion claimed and gave notices of deficiencies in the tax for both years. The petitioner thereupon filed two separate petitions with the Board of Tax Appeals for redetermination of the asserted deficiencies. Both petitions were consolidated for hearing and decision before the Board of Tax Appeals. (R. 38.) The Board of Tax Appeals held, erroneously we believe, that the dumps in question

did not constitute a mine within the meaning of the statute (R. 75) and entered its decisions that there was a deficiency in the income tax for the calendar year 1936 in the amount of $3625.45 and for the calendar year 1938 in the amount of $512.57. This petition for review is taken from those decisions. The facts are identical with respect to each year except as to the amounts involved, which are not in dispute.

STATEMENT OF POINTS TO BE URGED.

The Board of Tax Appeals erred:

1. In failing to hold that the ores and precious metals were naturally deposited in the dumps in question and that the same constituted a part of the taxpayer's mine within the meaning of Section 114 (b) (4) of the Revenue Acts of 1936 and 1938.

2. In holding that percentage depletion under said section of said acts is not allowable with respect to income derived from processing said dumps.

3. In holding that there were deficiencies in the income tax returns of the taxpayer for the years 1936 and 1938 by reason of the disallowance of the percentage depletion claimed by the taxpayer for those years.

4. In that its opinion and decision are contrary to its findings of fact.

5. In that its opinion and decision are not supported by its findings of fact and are contrary to law.

THE FACTS.

The petitioner acquired the American Flat property near Virginia City, Nevada, by purchase from Bullion Gold & Silver Mining Company on or about July 1, 1933 and during the taxable years in question was the owner of the property in fee. (R. 7-8, 17, 20-21, 30, 55.) Prior to such purchase and between the years 1872-1898 the predecessors of Bullion Gold & Silver Mining Company had removed from mines adjacent to the property a quantity of natural deposit ore material and placed the same upon the American Flat property. (R. 40-41.) Such ore material was taken from mines known as the Yellow Jacket, Crown Point, Belcher and Kentuck Mines. (R. 48-49.) The operators of these mines had made an arrangement with the Overman Mining Company, which was then the owner of the American Flat property, for the privilege of dumping such ore materials upon the American Flat properties. (R. 50.) The records concerning such arrangement were destroyed in the fire of 1906, but one of the operators of one of the mines testified that in 1907, the operators of the mines did not consider that they owned the dumps on the American Flat property. He testified that they considered that the Overman Mining Company, the owner of such property, was the owner of the dumps and the operators were "trying to make a dicker with the Overman Mining Company" for the privilege of working the dumps. (R. 50-51.) The dumps were not produced by the Overman mine. "They were just there." (R. 52.)

At the time the petitioner acquired the American Flat property, the dumps were from 60 to 80 feet high. (R. 66.) Their physical appearance after the petitioner had removed a portion of the rock by power shovel for processing is shown by the photograph marked Petitioner's Exhibit 1, the original of which has been transmitted to this Court for inspection. The dumps are indicated by the white spot about two inches from the righthand side of the picture and in about the center vertically. (R. 58.)

The material constituting the dumps was waste rock blasted from the mines and deposited upon the American Flat properties just as it was blasted. (R. 42.) It had never been milled or processed and no effort had been made to segregate it or remove any of the ore materials from the rock. (R. 41-42, 55.) "Processing" is the process whereby metal is extracted from the rock. The first step in processing is milling. (R. 42.) Milling consists of crushing the rock into an impalpable powder after which the powder is processed by whatever system of processing may be used. (R. 45.) "Tailings" are the products of the mill resulting after the rock has been milled and the powder has been processed. (R. 45.) The material constituting the dumps in question was not tailings in any sense of the word (R. 45) but was blasted rock in which the metal was still naturally deposited at the time of the acquisition by the petitioner of the property on which the dumps were located. (R. 65.)

SUMMARY OF ARGUMENT.

The Board of Tax Appeals disallowed percentage depletion claimed by the petitioner and found that there were deficiencies due for the taxable years in question by reason of its holding that the dumps did not constitute a mine within the meaning of the statute. While five specifications of error and points to be urged are set forth, if the Board was in error in failing to hold that the dumps constituted a mine and the minerals therein a natural deposit within the meaning of the statute, it will follow that the other points urged will be disposed of. The petitioner therefore confines its argument in this brief to the contention that the dumps and minerals therein constituted a mine or other natural deposit within the meaning of the statute.

ARGUMENT.

THE DUMPS CONSTITUTED A MINE WITHIN THE MEANING OF THE STATUTE.

The decision of the Board of Tax Appeals is predicated primarily upon the holding of the Board that the dumps in question did not constitute a mine within the meaning of the statute. (R. 75.) If this is considered a finding of fact, it is not such a finding of fact as must be deemed conclusive upon review. All of the evidence before the Board, including all of the testimony of the witnesses, is set forth in the record before this Court. There was no conflict in the evidence and it was uncontradicted. The review-

ing Court is not bound by facts determined by the lower Court based upon uncontradicted evidence.

5 *Corpus Juris Sec.* p. 558.

The question of what constitutes a "mine" within the meaning of a particular statute is a question of law for the Courts to determine.

In the well considered case of

Nephi Plaster & Mfg. Co. v. Juab County, 33 Utah 114, 118, 93 Pac. 53, 14 L.R.A. (N.S.) 1043,

the Supreme Court of Utah said:

> "The question, however, is what is to be deemed as being within the popular conception of a mine? Is it to be confined to the understanding that a farmer, stock raiser, or ordinary merchant has of the term? Or to what those who work in or come in contact with mines and mining rights generally and popularly understand it to be? Or is it to be understood, when found in a statute or Constitution, what the courts generally have held it to mean? In view that the decisions of courts are but the reflection of the common understanding with respect to particular things and the terms used in any industry, business, or calling, and are thus simply reduced to legal terms, we think that if the courts have construed and applied what is meant by the terms 'mine' and 'mines', then this meaning must control, and especially so when the term is used in some statute or constitution. This must be so for the simple reason that the term will then have acquired a legal meaning, which, unless the contrary clearly appears from the context, must be deemed to be the meaning intended to be applied to it in the law in which it is found."

There have been a number of federal cases in which the nature of a "tailings dump" has been considered in relation to Section 23 (m) of the Revenue Act. One of the latest of such cases is

Commissioner of Internal Revenue v. Kennedy Mining & Milling Co., 125 Fed. (2d) 399,

decided by this Court February 4, 1942.

In the case of

Atlas Milling Co. v. Jones, 10th Circuit, 115 Fed. (2d) 61,

relied upon by the Commissioner and cited in the decision of the Board of Tax Appeals, the Court had held that percentage depletion was not allowable in respect to the reworking of tailings. The Court in the *Atlas* case defined a "mine" as follows:

> "A 'mine' is an excavation in the earth from which ores, coal, or other mineral substances are removed by digging or other mining methods. In its broader sense it denotes the vein, lode, or deposit of minerals. Mining connotes the removal of minerals from a natural deposit. It does not embrace the reworking of mineral dumps artificially deposited from the residue remaining after the ore has been milled and concentrates removed therefrom. So. Utah Mines & Smelters v. Beaver County, 262 U.S. 325, 332. In the case last cited the court said:
>
> " 'The tailings, severed and removed from the mining claims, changed in character, placed on other and separate lands and having an ascertained and adjudicated value of their own, in our opinion, constituted a unit of property entirely apart from the mine from which they had been taken. See Forbes v. Gracey, 94 U.S. 762, 765.' "

The *Kennedy* case before this Court involved the reworking of tailings by the mine owner. The Commissioner contended before this Court, on authority of the definition given in the *Atlas* case, that the reworking of the tailings could in no sense be regarded as a mining operation. This Court held otherwise and distinguished the *Atlas* case on the ground that in that case, the taxpayer was a contractor which had contracted with the owner of the tailings dump to treat the tailings therein for a share of the proceeds. Neither party owned any mine.

The present case differs from the *Atlas* case in that the petitioner in this case acquired the dumps as a part of its mining property and owned them in fee. The case differs from the *Kennedy* case in that the dumps were created with waste rock taken from adjacent mines, not owned by the petitioner, from thirty to sixty years before the petitioner acquired the lands on which the dumps were deposited. This case differs from both the *Atlas* and *Kennedy* cases in that the dumps are not tailings in any sense of the word, had never been milled or processed when acquired by petitioner, but consisted of rock, just as it was blasted in which the metal was still naturally deposited. It also differs from both cases in that the petitioner's predecessor in ownership of the land was considered to have become the owner of the dumps thereon, and the only economic interest in the dumps is that of the petitioner, which is ownership in fee.

In 50 *Corpus Juris,* pages 768-769, it is stated:

> "The character of property may, in some instances, be changed from personalty to realty,

> or from realty to personalty, by the act of the owner or other person in dealing with it. * * * It is held, however, that, to convert an article which is a part of the realty into a chattel by severance, the act must be done by one having the right or authority to do so, and with the intention of so converting it, and that what is realty continues to be so until the owner by his election gives it a different character. * * * 'Tailings' from ore reduction, deposited on adjoining property with the consent of the owner, may become part of realty; *and severed rock deposited upon another's land and permitted to remain becomes real property.*" (Italics ours.)

In the case of *Anderson v. Helvering,* 310 U.S. 404, 407, 60 Sup. Ct. 952, 954, one of the cases relied upon by the respondent before the Board, the Court in discussing the question of depletion allowance in the case of oil and gas wells, said:

> "It is settled that the same basic issue determines both to whom income derived from the production of oil and gas is taxable and to whom a deduction for depletion is allowable. *That issue is, who has a capital investment in the oil and gas in place and what is the extent of his interest.* * * *" (Italics ours.)

In the case of *Helvering v. Bank Line Oil Co.,* 303 U.S. 362, 366, 367, 58 Sup. Ct. 616, 618, another case cited by the respondent, the Court said:

> "In order to determine whether respondent is entitled to depletion with respect to the production in question, we must recur to the fundamental purpose of the statutory allowance. The

> deduction is permitted as an act of grace. It is permitted in recognition of the fact that the mineral deposits are wasting assets and is intended as compensation to the owner for the part used up in production. United States v. Ludey, 274 U.S. 295, 302, 47 S. Ct. 608, 610, 71 L. Ed. 1054. The granting of an arbitrary deduction, in the case of oil and gas wells, of a percentage of gross income, was in the interest of convenience and in no way altered the fundamental theory of the allowance. United States v. Dakota-Montana Oil Co., 288 U.S. 459, 467, 53 S. Ct. 435, 438, 77 L. Ed. 893. The percentage is 'of the gross income from the property,'—a phrase which 'points only to the gross income from oil and gas.' Helvering v. Twin Bell Syndicate, 293 U.S. 312, 321, 55 S. Ct. 174, 178, 79 L. Ed. 383. *The allowance is to the recipients of this gross income by reason of their capital investment in the oil or gas in place.* Palmer v. Bender, 287 U.S. 551, 557, 53 S. Ct. 225, 226, 227, 77 L. Ed. 489." (Italics ours.)

The rock or ore material constituting the dumps was therefore a part of the realty purchased and owned by the petitioner and a part of its capital investment, of which the petitioner was, during the tax years in question, the sole owner.

There is nothing in the definition of a "mine" in the case of *Atlas Milling Company v. Jones,* supra, from which it can be said that the dumps were not a "mine" within the meaning of the statute. The extent of the holding of the *Atlas* case, so far as the definition is concerned, is that mining "does not embrace the reworking of mineral dumps artificially

deposited from the *residue remaining after the ore has been milled and concentrates removed therefrom".* (Italics ours.) The Court did say "a 'mine' is an excavation in the earth from which ores, coal, or other mineral substances are removed by digging or other mining methods". The Court was here defining a mine in relation to the residue remaining from processed ores and was not considering waste rock or ore material which had never been processed but which was a part of the realty on which it had been deposited and allowed to remain. The Court continued: "In its broader sense it denotes the vein, lode, or deposit of minerals." This statement was undoubtedly taken from 40 *Corpus Juris* page 734, which further elaborates upon the definition as follows:

> "In a broad or enlarged sense the term 'mine' denotes the 'vein,' 'lode,' or 'deposit' of mineral, and is also used to denote the place where, or the parcel of land on which, such mineral vein or deposit is found. *In this sense it is a certain part of the soil or of the earth's surface in which there are mineral deposits, and in which a person obtains not only a full right of ownership of the soil, but a right to remove the minerals therefrom and to dispose of them as he sees fit."* (Italics ours.)

To hold that the restricted definition of a mine should apply in this case would be to render meaningless the words "other natural deposits" in Section 23 (m) of the Revenue Act. Section (n) (2) of the same Act, before its amendment in 1932, provided with respect to *discovery* depletion that

> "In the case of *mines* discovered by the taxpayer * * * the basis for depletion shall be the fair market value of the property * * *." (Italics ours.)

In

Pacher Gravel Co., 21 B.T.A. 51,

and

Dunn & Baker, Inc. v. C. I. R., 30 B.T.A. 663,

the Board of Tax Appeals pointed out that the discovery section refers only to "mines", while Section 23 (m) refers to mines and "other natural deposits", and that the omission of these latter words from Section 23 (n) indicated an intention on the part of Congress that the word "mines" in the discovery section was used in its restricted or narrow sense. The Board held that a gravel pit and a stone quarry were not "mines" as the term is used in the discovery section, although the Board said in the *Dunn & Baker* case:

> "Undoubtedly, petitioner's deposit of stone is a natural deposit which Congress specifically directs shall be subject to depletion allowances, but which it carefully refrained from including in the discovery provisions of the statute."

If the reasoning of the Board was correct in those two cases, as we believe it was, then conversely, the inclusion of the words "other natural deposits" in Section 23 (m), the percentage depletion section, indicates an intention that the word "mines" is used in that section in its broad sense. This construction of the statute applied to the present case would not

be inconsistent with holdings of the Courts that a tailings deposit is not a mine, because a tailings deposit is obviously not a natural deposit. After the rock has been milled into the powder from which the tailings deposit is created, such metal as remains in the powder has been disturbed and is not naturally "in place". In the case of the dumps in question, the gold and silver content was just as much in place in the rocks as if those rocks had never been removed from underground. The ore was not free in a metallurgical sense. The very fact that milling and reduction to an impalpable mass was necessary negatives any theory to the contrary.

The dumps were a certain part of the earth's surface containing mineral deposits, naturally in place in the rocks. They had become a part of the realty purchased and owned by the petitioner. The petitioner had not only the right of ownership but the right to mine the dumps and remove the minerals and to dispose of them as it should see fit. It is respectfully submitted that its operations in doing so were mining operations, and that under the proper definition of the word "mines" used in connection with the words "other natural deposits", in Section 23 (m), the dumps were the petitioner's mines and the minerals therein were the petitioner's natural deposits within the meaning of that section. It is therefore respectfully submitted that the decision of the Board of Tax Appeals in failing to so hold was contrary to and not supported by its findings of fact, and was contrary to law. By reason thereof, it is

respectfully submitted that the Board erred in disallowing percentage depletion and in finding that there were any deficiencies for the taxable years in question.

Dated, San Francisco,
September 10, 1942.

Respectfully submitted,
WILLIAM A. BOEKEL,
JOHN D. GALLAHER,
Attorneys for Petitioner.

No. 10198

In the United States Circuit Court of Appeals for the Ninth Circuit

CONSOLIDATED CHOLIAR GOULD & SAVAGE MINING COMPANY, A CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR THE RESPONDENT

SAMUEL O. CLARK, JR.,
Assistant Attorney General.
SEWALL KEY,
BERNARD CHERTCOFF,
Special Assistants to the Attorney General.

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In the United States Circuit Court of Appeals for the Ninth Circuit

No. 10198

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v.

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ON PETITION FOR REVIEW OF THE DECISION OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR THE RESPONDENT

OPINION BELOW

The opinion of the United States Board of Tax Appeals (R. 71–79) is reported at 46 B. T. A. 241.

JURISDICTION

This appeal involves income taxes for the calendar years 1936 and 1938. The notice of deficiency for the year 1936 is dated May 14, 1940 (R. 11), and the taxpayer's petition for redetermination was filed with the Board of Tax Appeals on August 10, 1940 (R. 1). The notice of deficiency for the year 1938 is dated July 11, 1940 (R. 25), and the taxpayer's petition for redetermination was filed on October 7, 1940

(R. 3). The jurisdiction of the Board of Tax Appeals rests upon Section 871 of the Internal Revenue Code. The decisions of the Board were entered on March 25, 1942 (R. 80, 81), and the petition for review by this Court was filed on June 24, 1942 (R. 82–87). The jurisdiction of this Court rests upon Sections 1141–1142 of the Internal Revenue Code.

QUESTION PRESENTED

Whether the taxpayer is entitled, under Sections 23 (m) and 114 (b) (4) of the Revenue Acts of 1936 and 1938, to deduct percentage depletion in respect of income derived during the tax years 1936 and 1938 from the extraction of gold from previously unmilled low-grade ores produced by others from mines on their properties and deposited and dumped by them upon the land of the taxpayer's predecessor in title.

STATUTES AND REGULATIONS INVOLVED

These will be found in the Appendix, *infra*.

STATEMENT

The facts as found by the Board (R. 72–75) may be summarized as follows:

The taxpayer, a California corporation having its principal office at San Francisco, California (R. 72), acquired by purchase in 1933 the so-called American Flat property near Virginia City, Nevada, and during the years in issue owned the property in fee (R. 73). Prior to such purchase and between the years 1872 and 1898 the owners of neighboring mining properties had transported and dumped unmilled low-grade ore material from their mines, which they considered to be

waste, upon the American Flat property, then owned by the Overman Mining Company. (R. 73–74. See also R. 51–53.) The Overman Mining Company allowed them that privilege, but at the time such materials were dumped on Overman's property it was considered that the Overman Company thereby became the owner of those materials. (R. 74.)

Taxpayer erected a mill in 1934 about 2,000 feet from the dumps, and began processing the material in them. (R. 56–57, 75.) The ore materials were removed from the dumps to the mill, for processing, by use of a power shovel and trucks. The dumps in question did not constitute mines. (R. 75.)

In reporting its taxable income for the years in issue the taxpayer claimed percentage depletion upon its gross income from processing the material in the dumps. The Commissioner of Internal Revenue ruled that the dumps did not constitute mines or other natural deposits within the meaning of Section 23(m), disallowed the claimed deductions for percentage depletion with respect to the gross income derived from processing the material in the dumps, and determined deficiencies accordingly. (R. 13–16, 25–29.) The Board of Tax Appeals sustained the Commissioner's determination. (R. 71–79.)

SUMMARY OF ARGUMENT

The taxpayer is not entitled to percentage depletion upon the gross income realized from the processing of the abandoned rock dumps. Those dumps did not constitute mines or natural deposits within the ordinary meaning of those words. The controlling factor

is that the dumps were not the product of the taxpayer's land, but were the product of neighboring lands. As in the case of tailings, the dumps were the residue of an older, less efficient method of treating the product of a mine.

The instant case not only falls without the plain meaning of the statutory provisions granting the depletion deduction, but is also outside of the underlying principle upon which the deduction is based. That underlying principle is to compensate for the severance and disposition of part of the substance of the land. Here the properties which suffered depletion were the neighboring mines from which the ore had been extracted. The plain fact of the matter is that when the taxpayer worked the dumps in question it was engaged in processing, not in mining.

ARGUMENT

The taxpayer is not entitled to percentage depletion in respect of its gross income from the extraction of gold from the abandoned rock dumps of neighboring producers

Section 23(m) of the Revenue Acts of 1936 and 1938 (Appendix, *infra*) allows a deduction from gross income for depletion "In the case of mines, oil and gas wells, other natural deposits, and timber." And Section 114(b)(4) permits a taxpayer to compute the depletion allowance upon the basis of a percentage of the gross income from the property during the taxable year. In approaching the issue presented in the instant case, it is important to note that since the above sections are ones granting a deduction, they must be

strictly construed and the taxpayer must be able to show that he comes clearly within their terms. *Nevada-Massachusetts Co.* v. *Commissioner,* 128 F. 2d 347 (C. C. A. 9th), and cases there cited.

We agree with the taxpayer that the only issue requiring decision in the instant case is whether the abandoned dumps of rock which had been deposited by neighboring producers upon the land now owned by the taxpayer constituted mines or other natural deposits within the meaning of Section 23(m).

It is the Government's position that under no construction of the statute, and certainly not under the strict construction which is required, may these dumps be held to constitute mines or other natural deposits. It is fundamental that the term "mines" is to be given its ordinary meaning in the construction of the section in question. *Ozark Chemical Co.* v. *Jones,* 125 F. 2d 1 (C. C. A. 10th), certiorari denied, June 1, 1942.[1] The term "mine" is defined in Webster's New International Dictionary (1933) as "A subterranean cavity or passage; esp.: *a* A pit or excavation in the earth, from which ores, precious stones, coal, or other mineral substances are taken by digging; as, a gold *mine;* an asphalt *mine;* * * *." In Bouvier's Law Dictionary (Rawle's Third Rev.) a mine is defined as an excavation in the earth for the purpose of obtaining minerals. Similar definitions are to be found in

[1] See also *Helvering* v. *Hutchings,* 312 U. S. 393; *Magnano Co.* v. *Hamilton,* 292 U. S. 40, 46; *Avery* v. *Commissioner,* 292 U. S. 210; *Woolford Realty Co.* v. *Rose,* 286 U. S. 319, 327; *Old Colony R. Co.* v. *Commissioner,* 284 U. S. 552, 560; *DeGanay* v. *Lederer,* 250 U. S. 376.

Black's Law Dictionary (Third ed.), in Lindley On Mines (Third ed.), Secs. 88–89, and in White, Mines and Mining Injuries, Law (1903), Secs. 1–2. These authorities point out that the term was apparently derived from the Latin word *minare* signifying a subterranean passage.

A similar definition was used to test the meaning of the term in the very sections here under consideration in *Atlas Milling Co.* v. *Jones,* 115 F. 2d 61 (C. C. A. 10th), certiorari denied, 312 U. S. 686, in which the court said (p. 63):

> A "mine" is an excavation in the earth from which ores, coal, or other mineral substances are removed by digging or other mining methods. In its broader sense it denotes the vein, lode, or deposit of minerals. Mining connotes the removal of minerals from a natural deposit.

The *Atlas* case held that a deposit of tailings did not constitute a mine within the meaning of the sections here involved and that holding was approved by this Court in *Commissioner* v. *Kennedy Min. & M. Co.,* 125 F. 2d 399. See also *Britt* v. *Commissioner,* 43 B. T. A. 254. We submit that the instant case is governed by the decision in the *Atlas* case. The taxpayer has attempted to distinguish the *Atlas* case on the ground that there is a difference between a deposit of tailings and the dumps of rock here involved. That that distinction is without merit is clearly indicated by the opinion in the *Kennedy* case, *supra.* Both tailings and rocks such as are here involved were originally products of a mine. Both are ores contain-

ing minerals. It is immaterial that in one case some of the minerals have already been removed. Insofar as any mineral remains in the tailings, it is there in exactly the same state in which it is present in rocks which have not yet undergone any treatment. Both are the residue of an older, less efficient method of treating the product of a mine. The controlling factor in both the *Atlas* and the case *sub judice* is that the deposits represented the product of other lands. This is clearly brought out by the decision in the *Kennedy* case, *supra*. That case involved the reworking of tailings *by the mine owner*. The tailings in question represented the product of a mine upon the taxpayer's land. It was held that the taxpayer there was entitled to a depletion deduction with respect to the income derived from the reworking of the tailings because that income came from ores which had been taken from the taxpayer's mine. It was pointed out that it was immaterial that the ores had been removed from the mine in prior years since several years may elapse between the removal of the ores from the earth and the final sale of the metal in the normal course of mining. The *Atlas* case, *supra,* was distinguished on the ground that the person who reworked the tailings there was not the owner of the mine from which the tailings had come. That is exactly the situation in the instant case.

The taxpayer argues that the dumps in question were a part of the realty purchased and owned by it. We do not believe it important to determine whether under the law of Nevada these rocks might have been

held to be realty for some purposes. The rocks undoubtedly became personal property when they were extracted from the neighboring land. See the *Atlas* case, *supra,* at page 63, and cases there cited. Whether or not when those rocks were placed on the land which the taxpayer now owns they became a part of the realty in the sense that they would pass with a conveyance of land is wholly immaterial.[2] Those rocks clearly did not become a mine any more than a building erected on a plot of land is a mine although undoubtedly it would pass with a conveyance of the land.

The words "other natural deposits" in Section 23(m) support rather than refute the Government's position in the instant case. By "natural deposits" Congress undoubtedly meant natural deposits other than those normally described by the phrase, "mines, oil and gas wells," as, for example, a sodium sulphate deposit (see *Ozark Chemical Co.* v. *Jones, supra*) or a gravel pit or a stone quarry (see *Parker Gravel Co.* v. *Commissioner,* 21 B. T. A. 51; *Dunn & Baker, Inc.* v. *Commissioner,* 30 B. T. A. 663). In any event, it is clear from the use of the words "other natural deposits" that the words preceding them, *i. e.,* "mines, oil and gas wells," were used only to refer to natural deposits of minerals, oil and gas in the earth. The plain fact of the matter is that the dumps in question were placed there by man and not by nature.

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[2] This was the issue involved in *Eggborn* v. *Smith*, 114 Va. 745, 77 S. E. 593, which is cited in 50 Corpus Juris 769, as authority for the statement that "severed rock deposited upon another's land and permitted to remain becomes real property."

The contention that the metal was naturally in place in the rocks in question and therefore constituted a "natural deposit" within the meaning of Section 23(m) is patently erroneous. If this were true, then the tailings deposit involved in the *Atlas* case, *supra,* would have come within the section, for it is equally true with respect to tailings that such metal as is present is a "natural deposit" in the sense that the metal came to be there as the result of natural forces and had not yet been removed by man. Moreover, it follows from the taxpayer's contention that these rocks would have been mines or natural deposits if they had been sold at the point of removal from the earth to a third party. Under the taxpayer's theory the purchaser would be engaged in mining when he undertook the separation of the metal from the rock. That the theory is erroneous is apparent from *Helvering* v. *Bankline Oil Co.,* 303 U. S. 362. There the taxpayer owned casing-head gas contracts under which it operated a plant for separating natural or "wet" gas into its component parts, gasoline and dry gas. Under the contracts the natural gas was taken by the taxpayer at the mouth of the wells and it was required to install and maintain the necessary pipe lines from the wells to its plants. The court held that the taxpayer was a processor and had no depletable interest in the gas, stating that (p. 368):

> The controlling fact is that respondent had no interest in the gas in place. Respondent had no capital investment in the mineral deposit which suffered depletion and is not entitled to the statutory allowance.

This principle is dispositive of the instant case for here also the taxpayer had no investment in the minerals in place or in the land from which they came. The properties which suffered depletion were the neighboring mines from which the ore had been extracted.

The underlying principle upon which the depletion deduction is based was stated by the Supreme Court in *Anderson* v. *Helvering,* 310 U. S. 404, 408, as follows:

> The deduction is therefore permitted as an act of grace and is intended as compensation for the capital assets consumed in the production of income through the severance of the minerals. *Helvering* v. *Bankline Oil Co.,* 303 U. S. 362, 366–367. The granting of an arbitrary deduction, in the interests of convenience, of a percentage of the gross income derived from the severance of oil and gas, merely emphasizes the underlying theory of the allowance as a tax-free return of the capital consumed in the production of gross income through severance. *Helvering* v. *Twin Bell Oil Syndicate,* 293 U. S. 312, 321; *United States* v. *Dakota-Montana Oil Co.,* 288 U. S. 459, 467.

The emphasis throughout the foregoing quotation is upon the severance of part of the substance of the property as the basis for the depletion allowance. In the instant case, the ore bearing rocks from which the taxpayer extracted gold did not come from mines located on its property but from mines located on adjacent properties. The severance was from the neighboring properties and it was those properties which were depleted by the extraction of the ore.

We submit that the instant case does not come within the plain meaning of the words of the statutory provisions permitting the deduction, nor of the principle underlying them. With respect to the dumps in question the taxpayer was not engaged in mining but in processing. The Commissioner and the Board have therefore properly denied the claimed deductions.

CONCLUSION

The decision of the Board of Tax Appeals should be affirmed.

Respectfully submitted.

SAMUEL O. CLARK, JR.,
Assistant Attorney General.
SEWALL KEY,
BERNARD CHERTCOFF,
Special Assistants to the Attorney General.

NOVEMBER, 1942.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * *

(n) *Basis for Depreciation and Depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

* * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) *Basis for Depletion.*—

* * * * *

(4) *Percentage depletion for coal and metal mines and sulphur.*—The allowance for depletion under section 23(m) shall be, in the case of coal mines, 5 per centum, in the case of metal mines, 15 per centum, and, in the case of sulphur mines or deposits, 23 per centum, of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the

property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property. A taxpayer making his first return under this title in respect of a property shall state whether he elects to have the depletion allowance for such property for the taxable year for which the return is made computed with or without regard to percentage depletion, and the depletion allowance in respect of such property for such year shall be computed according to the election thus made. * * *

The corresponding provisions of the Revenue Act of 1938 are identical.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 23(m)–1. *Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.*—Section 23(m) provides that there shall be allowed as a deduction in computing net income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements. Section 114 prescribes the bases upon which depreciation and depletion are to be allowed.

Under these provisions of the Act the owner of an interest in mineral deposits, mineral properties, or timber, whether freehold or leasehold, is allowed annual depletion and depreciation deductions which, in the aggregate, will return to him the cost or other basis of such property as provided in section 113, plus, in either case, subsequent allowable capital additions (see articles 23(m)–15 and 23(m)–16) with the following exceptions and qualifications:

* * * * *

When used in these articles (23(m)–1 to 23(m)–28) covering depletion and depreciation—

* * * * *

(*b*) A "mineral property" is the mineral deposit, the development and plant necessary for its extraction, and so much of the surface of the land only as is necessary for purposes of mineral extraction. The value of a mineral property is the combined value of its component parts.

(*c*) A "mineral deposit" refers to minerals only, such as the ores only in the case of a mine, to the oil only in the case of an oil well, and to the gas only in the case of a gas well, and to the oil and gas in the case of a well producing both oil and gas. The cost of a mineral deposit is that proportion of the total cost of the mineral property which the value of the deposit bears to the value of the property at the time of its purchase.

* * * * *

The corresponding provisions of Treasury Regulations 101, as originally promulgated under the Revenue Act of 1938, are the same. T. D. 4960, 1940–1 Cum. Bull. 38, 39, made the following amendments to Treasury Regulations 101:

Regulations 101 [Part 9, Title 26, Code of Federal Regulations, 1939 Sup.], as made applicable to the Internal Revenue Code by Treasury Decision 4885, approved February 11, 1939 [C. B. 1939–1 (Part 1), 396] [Part 465, Subpart B of such Title 26], in so far as they prescribe rules relative to the allowance of depletion and depreciation deductions under sections 23(m) and 114 of the Internal Revenue Code, are hereby amended as follows:

(1) The second, third, and fourth paragraphs of article 23(m)–1 [section 9.23(m)–1] are amended to read as follows:

Under such provisions, the owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. An economic interest is possessed in every case in which the taxpayer has acquired, by invest-

ment, any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production. Thus, an agreement between the owner of an economic interest and another entitling the latter to purchase the product upon production or to share in the net income derived from the interest of such owner does not convey a depletable economic interest.

The adjusted basis of depreciable property is returnable through annual depreciation deductions. Depreciation and depletion deductions on the property of a corporation are allowed to the corporation and not to its shareholders. (But see article 115–6 [section 9.115–6].) The principles governing the apportionment of depreciation in the case of property held by one person for life with remainder to another person and in the case of property held in trust are also applicable to depletion. (See article 23(l)–1 [section 9.23(l)–1].)

(2) The first sentence of article 23(m)–1(*c*) [section 9.23(m)–1(*c*)] is amended to read as follows:

The term "mineral deposit" refers to minerals in place.

U. S. GOVERNMENT PRINTING OFFICE: 1942

No. 10203

United States
Circuit Court of Appeals
For the Ninth Circuit.

APARTMENT OPERATORS ASSOCIATION, a corporation,

Petitioner,

vs.

COMMISSIONER OR INTERNAL REVENUE,

Respondent.

Transcript of the Record

Upon Petition to Review a Decision of the United States Board of Tax Appeals

ROTARY COLORPRINT, 590 FOLSOM ST., SAN FRANCISCO

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

APPEARANCES:

For Taxpayer:

E. J. MINER, C. P. A.
EDWARD E. MERGES

For Comm'r:

T. M. MATHER [1*]

United States Board of Tax Appeals

Docket No. 106666

APARTMENT OPERATORS ASSOCIATION,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION

The above named petitioner hereby petitions for a redetermination of the deficiency as set forth by the Commissioner of Internal Revenue in his notice of deficiency, (IT;90D:JW, dated December 16, 1940), and as a basis of its proceedings alleges as follows:

1. The notice of deficiency, (a copy of which is attached and marked Exhibit A), was mailed to the petitioner December 16, 1940.

*Page numbering appearing at top of page of original certified Transcript of Record.

2. The petitioner is a non-profitable corporation, incorporated under the laws of the State of Washington, with its office at 664 Empire Building, Seattle, Washington. The tax return here involved was filed with the Collector at Tacoma, Washington. The members of this corporation are owners and operators of apartment houses. Its purpose is that of securing and disseminating information of mutual interest among its members.
3. The taxes in controversy are Income Taxes for the calendar year 1938, in the amount of $107.49, and excess profits taxes in the amount of $103.19.
4. The determination of tax set forth in the said notice of deficiency is based upon the following error:

   The petitioner is a non-profitable corporation. There is no outstanding capital stock, and no distributions are made to members. Practically all of the income of the corporation is derived from assessments against members of the organization. Any excess of income over expenses is due entirely to those assessments, which are voluntarily accepted by the members. No profit inures to the benefit of the members, or any one or more of them. The corporation does not have a profit. It manufactures nothing; it buys nothing to sell, and it sells nothing whereupon a profit could be realized. The alleged profit mentioned in

the notice of deficiency represents the excess of contributions of members over expenses which excess was used in the ensuing year's expenses. [2]

Whereupon, the petitioner prays that this Board may hear the proceeding, and find that there is no tax liability in this case.

E. J. MINER, C. P. A.
Counsel for Petitioner.
Alaska Building,
Seattle, Wash.

(Duly verified.) [3]

EXHIBIT A

No. 42420-W SN-IT-3

TREASURY DEPARTMENT
INTERNAL REVENUE
SERVICE

Seattle, Washington
December 16, 1940.

Seattle Division
350 Federal Office Building
IT:90D:JW
Apartment Operators Association
664 Empire Building
Seattle, Washington

Sirs:

You are advised that the determination of your income tax liability for the taxable year(s) ended

December 31, 1938, discloses a deficiency of $107.49 and that the determination of your excess-profits tax liability for the year(s) mentioned discloses a deficiency of $103.19 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiencies mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiencies.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, Seattle, Washington, for the attention of IT:90D:JW. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

GUY T. HELVERING,

Commissioner.

By GEO. C. EARLEY

Internal Revenue Agent in Charge.

Enclosures:

Statement

Form of waiver.

JW-ah [4]

STATEMENT

IT:90D:JW

Apartment Operators Association
664 Empire Building
Seattle, Washington

Tax Liability for the Taxable Year Ended December 31, 1938:

	Liability	Assessed	Deficiency
Income Tax	$107.49	None	$107.49
Excess-Profits Tax	$103.19	None	$103.19

In making this determination of your income and excess-profits tax liability, careful consideration has been given to the report of examination dated April 30, 1940; to your protest dated June 14, 1940; and to the statements made at the conferences held August 26, 1940 and December 3, 1940.

A copy of this letter and statement has been mailed to your representative, Mr. E. J. Miner, Central Building, Seattle, Washington, in accordance with the authority contained in the power of attorney executed by you and on file with the Bureau.

It is held that you are not exempt from income and excess-profits tax under any provision of the Revenue Act of 1938.

ADJUSTMENTS TO NET INCOME

Net income as disclosed by return	$941.09
Nontaxable income and additional deductions:	
(a) Depreciation	81.17
Net income adjusted	$859.92

EXPLANATION OF ADJUSTMENTS

(a) It is held that depreciation on your business assets in the amount of $81.17 is allowable in the computation of your taxable net income for the year 1938. The schedule of income and deductions accompanying your return did not contain any deduction for depreciation. [5]

COMPUTATION OF TAX

EXCESS-PROFITS TAX COMPUTATION

Value of capital stock as declared in the capital stock tax return for year ended June 30, 1938	None
Net income for excess-profits tax computation	$ 859.92
Net income subject to excess-profits tax	$ 859.92
Excess-profits tax assessable (12 per cent of $859.92)	$ 103.19
Excess-profits tax assessed:	
Original, Account No. 866783	None
Deficiency of excess-profits tax	$ 103.19

INCOME TAX COMPUTATION

Tax on Special Classes of Corporations

Net income for excess-profits computation	$ 859.92
Less:	
Excess-profits tax (cash basis)	None
Net income	$ 859.92
Special class net income	$ 859.92
Corporations with Net Incomes of Not More Than $25,000	
Income Tax assessable; 12½% of $859.92	$ 107.49
Income tax assessed:	
Original, Account No. 866783	None
Deficiency of income tax	$ 107.49

[Endorsed]: U.S.B.T.A. Filed March 17, 1941. [6]

[Title of Board and Cause.]

ANSWER

Comes Now the Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed herein, admits, denies and alleges as follows:

1. Admits the allegations contained in paragraph 1 of the petition.

2. Denies that the petitioner is a non-profit corporation, and alleges that petitioner is in a business ordinarily carried on for profit. Admits that petitioner was incorporated under the laws of the State of Washington and has its office at 664 Empire Building, Seattle, Washington. Admits that petitioner filed its return with the Collector at Tacoma, Washington. Admits that petitioner owns and operates apartment houses. Denies the remaining allegations contained in paragraph 2 of the petition. [7]

3. Admits that the taxes in controversy are income and excess-profits taxes for the calendar year 1938, but denies the remaining allegations contained in paragraph 3 of the petition.

4. Denies that the Commissioner erred as alleged in paragraph 4 of the petition. Denies the allegations of fact contained in said paragraph 4 of the petition.

5. Denies generally and specifically each and every material allegation contained in the petition, not hereinbefore specifically admitted, qualified or denied.

Wherefore, it is prayed that the petitioner's appeal be denied and that the Commissioner's determination of deficiency be approved.

(Signed) J. P. WENCHEL,
BHN
Chief Counsel,
Bureau of Internal Revenue.

Of Counsel:
ALVA C. BAIRD,
Division Counsel.
B. H. NEBLETT,
Special Attorney,
Bureau of Internal Revenue.

Accepted for Defense Apr. 5, 1941.
BHN: mo 4/5/41.

[Endorsed]: U.S.B.T.A. Filed Apr. 14, 1941. [8]

TESTIMONY

[Title of Board and Cause.]

Federal Office Building,
Seattle, Washington,
September 8, 1941.

Met pursuant to notice.
Before: Hon. John M. Sternhagen.

Appearances: Edward E. Merges, Esq., 1012 Lowman Building, Seattle, Washington, appearing for the petitioner.

T. M. Mather, Esq., 1215 Smith Tower Building, Seattle, Washington, appearing for the respondent. [10]

PROCEEDINGS

The Court: Docket No. 106666, Apartment Operators. Who appears for the petitioner?

Mr. Merges: My name is Edward Merges, if the Court please. I would like to state to the Court and counsel at this time that I have not been admitted to practice before the Board of Tax Appeals. I wrote a letter to the clerk in Portland telling him what the situation was, and I discussed it with him this morning, and I have prepared an application and will submit it immediately upon the proceeding of this matter.

The Court: Have you read the rules?

Mr. Merges: Yes, your Honor, I have.

The Court: Are you in all respects eligible for admission to practice?

Mr. Merges: I am, your Honor.

The Court: I will recognize you for the purpose of this case with the understanding that you will complete your application and admission promptly.

Mr. Merges: Thank you.

Mr. Mather: T. M. Mather, for the respondent.

The Court: Proceed.

STATEMENT OF CASE ON BEHALF OF THE PETITIONER

Mr. Merges: If your Honor please, the issues

of this case are quite simple. The only issue is whether or not the [12] Apartment Operators Association of Seattle is subject to income and excess profits tax for the year 1938.

The petitioner is a non-profit corporation formed under the laws of the State of Washington relating to non-profit corporations. There is no outstanding capital stock, no distributions are made to members of any kind, and practically all the income of the corporation is derived from assessments of members.

There is no profit enuring to the benefit of any of the members.

The corporation manufactures nothing and does not attempt to distribute any profits to its members.

The petitioner claimed exemption under Section 101 of the Income Tax Laws, Sub-Section 7, which reads, "Business leagues, chambers of commerce, real estate boards, or boards of trade not organized for profit, and no part of the net earning of which enures to the benefit of any private shareholder or individual."

The purpose of our case, if your Honor please, principally, is to present to the Court a picture of just what the Apartment Operators Association is.

The Court: What do you claim to be within the language that you read there?

Mr. Merges: We claim to be, your Honor, first——

The Court: A business league? [13]

Mr. Merges: Yes. I think that is really our whole case, your Honor.

Mr. Mather: If your Honor please, this appeal involves the deficiency of $107.49 income tax, and $103.19 excess profits tax for the year 1938. The only question is the question of whether or not the petition should be exempt.

The Court: Did the petitioner claim exemption originally and pay no tax?

Mr. Mather: If your Honor please, no return was filed by the petitioner. Then, when the return was due, later, a return was filed in which they claimed exemption. They reported no income. It is the position of the respondent that the petitioner is engaged in business, and in the type of business normally carried on for profit.

I think the evidence will show that it bought and sold merchandise at a profit; that it published a journal and accepted advertising in that publication.

Now, those are operations that are normally carried on at a profit. They claim a deficiency on that basis.

The Court: Make your case, Mr. Merges.

Mr. Merges: Mr. Williams, will you take the stand, please?

HARRY T. WILLIAMS

a witness on behalf of the Petitioner was duly sworn and testified as follows: [14]

(Testimony of Harry T. Williams.)

Direct Examination

Q. (By Mr. Merges): Will you state your name to the Court, please?

A. Harry T. Williams.

Q. Will you state your official capacity with reference to the Apartment Owners' Association?

A. Executive Secretary and Treasurer.

Q. And how long, Mr. Williams, have you been so engaged?

A. During the past sixteen years, or seventeen years.

Q. Are you familiar with the business carried on by the association? A. Yes.

Q. Are you familiar with the corporate setup?

A. Yes; I am one of the incorporators.

Q. Will you tell me when the Apartment Owners Association was incorporated?

A. December 3, 1937, I think it was.

Q. And was it incorporated, Mr. Williams, under Section 3888 and subsequent sections of Remington's Revised Statutes relating to corporations not formed for a profit?

A. It was a non-profit organization.

Q. Will you tell me, Mr. Williams, the objects and purposes of this corporation?

A. The usual objects and purposes of any trade association is to gather and disseminate information of benefit to its [15] members in the operation and conduct of their business, to promote uniform business methods, and in general, to do everything

(Testimony of Harry T. Williams.)

possible to promote the best interest and welfare of the members in so far as the particular business of theirs might be applicable to the association's business, which was a profit operation.

Q. Are there any certificates of stock issued to members? A. None.

Q. Are any dividends paid to members?

A. None.

Q. Just what benefit do the members of the association derive from it, Mr. Williams?

A. The receipt of information affecting their business gathered from all parts of the nation, the exchange of experiences, good and bad, in order that they might adjust their own business to derive the greatest possible benefits from their investments.

Q. Could you, in order to make this matter—that is, the functions of the association entirely clear to the Court, give us a few examples of what the association does for its members?

A. Well, it conducts, amongst other things, a tenant reporting system in which the operators report to the association their experiences with the tenants, which are filed in the office, who have space in apartment buildings and who have access to them. [16]

Q. What was the last of that, please?

A. Which are filed in the office, and to which they have access.

Q. And what is the purpose of that?

A. In respect to prospective tenants that might apply for space in their buildings. That is to pro-

(Testimony of Harry T. Williams.)

tect the industry, of course, against destructive or non-pay tenants.

Q. What is the information that you disseminate?

A. The legislative, general information, general business information, especially that which specifically applies to apartment houses, legislative trends, the effect of legislation upon the business, and guidance and counsel to keep them in line with legislation. In other words, to do everything possible to promote their common welfare in the business.

Q. Is it true that if a tenant or, rather, if a member, owner, or operator, has some difficulty with some tenant or some problem in the operation of his apartment, that he is privileged to and frequently does consult the association?

A. That is right. Any problem that would arise in their business, they can take it up with the association for the purpose of having available the accumulative experiences of the association in problems of like nature.

Q. Do any of the members of the association receive any dividends in any form whatsoever?

A. None. [17]

Q. I believe something was said in counsel's opening statement regarding the selling of goods or certain items of personal property. Would you describe to the Court just what the association does in that line?

A. Well, we have, for instance, printers' sup-

(Testimony of Harry T. Williams.)

plies for our members, forms peculiar to apartment operation, the majority of which are not available. The only way you could get them, you would have to have some printer make them up for you and, of course, the individual member having it done, the cost would be too great; so through their association, they collectively order a large quantity at once. The forms are designed by the association for the specific application in this locality. For instance, our receipt books differ from the common receipt book bought in a store, you could not buy one like it; you would have to have it printed. We prepare those forms, and they are broken down to approximately cost and sold to the membership. Naturally, we have to preserve a margin for set *losse,* and so forth.

Q. Could you name some article of personal property that is sold by the association to its members or, rather, purchased by the association for its members?

A. Well, that is practically the bulk of our printed forms; it is about the bulk of what we call our purchase and supply department.

Q. It is your testimony, then, Mr. Williams, that the Apart- [18] ment Operators Association acts as a sort of a purchasing agent for its members with regard to certain articles relating to the operation of apartment houses?

A. That is correct.

Q. And does the association make any——

A. (Interposing): May I amplify that?

(Testimony of Harry T. Williams.)

Q. Surely.

A. As a matter of fact, a member will call us in respect to some peculiar need of his It is a part of our function to find out for him where the article can be obtained, and it is a part of our function to see whether we can obtain it for him at a lower cost.

Q. Does the association make any profit from the sale of these articles?

A. No. The price is broken down as close to cost as we dare go and, in establishing the cost, of course, it is the actual purchase cost—the unit cost of the bulk purchase. In other words, there is no overhead; there is no overloading of the proper charges that would go in an ordinary retail business. For instance, no portion of the rent or the wages of employees. The other expenses of the association, that is all paid out of dues. In other words, it is a peculiar incidental service to the members.

Q. Does the association make any profit in any other way?

A. It did publish a journal, and that was discontinued, with [19] a great deal of pleasure on my part, and as soon as we found that that was, or might be the subject of income tax. That was not only an expense, but a headache to us.

Q. What was the purpose in publishing the journal?

A. For the purpose of gathering and disseminating among our membership the information that

(Testimony of Harry T. Williams.)

was gathered from the four corners of the nation affecting the apartment business.

The Court: When was that published?

The Witness: It was published monthly in the form of apartment——

The Court: I mean at what time did you publish it and at what time did you stop it?

The Witness: It was being published—we had one on and off during the entire life of the association. It was a voluntary association up until 1937, and it was incorporated. It was published during this year in question here in 1938, with the exception of two months, I believe, in that year. We used to skip months from time to time.

The Court: When did you stop publishing it?

The Witness: After we found there might be a question as to——

The Court: When was that?

The Witness: That was in 1939.

Q. (By Mr. Merges): That was after the year 1938?

A. Yes, that was after the year 1938. [20]

Q. What was the contents of this journal, principally?

A. Purely—Well, for instance, there was legal comment—comment on legal cases affecting apartment operations—legislative comment on legislation affecting it. Then there were technical articles on apartment operation gathered from other apartment publications in the nation.

Q. And did you find it a more efficient way,

(Testimony of Harry T. Williams.)

and a cheaper way, of disseminating this information to your members than by letter or pamphlet?

A. Naturally, because in one issue, in general, we might cover twenty or thirty subjects which would require rather numerous correspondence. The postage and the cost of disseminating information that way would have been prohibitive; so by the expedient of firms who were supplying apartment houses, advertising in the journal. That, of course, bore a portion of the expense. The journal, in our books, of course, no attempt was made to break down the overhead. Until this matter came up, we had never done it, and then we found that, of course, we were operating both the journal and the supply department under a heavy loss. The only gain that we could possibly have in the association was through dues.

Q. Did the journal ever make a profit in its history?

A. A paper profit, yes. That is, in other words, the income was greater than the outgo for the journal alone; but there was no remuneration for the services of the editor and the rent, [21] and so forth, and so on. It could not possibly be published except as an incidental service to the members through the trade association.

Q. What was done with the profit or surplus of the association, if any?

A. Well, the substance of the association, which is the ideal, of course, of any trade association—

(Testimony of Harry T. Williams.)

it is the ideal of any trade secretary, of course, to have a cushion for twelve months' operation if he possibly can, in case of adverse circumstances. We have never been able to do better than three or four months. The surplus practically amounts to the cost of three to four months' operation. We have never been able to get it any higher.

Q. Showing you this document, Mr. Williams, will you tell me what that is?

A. That is the copy of the Articles of Incorporation of the Apartment Operators Association.

Q. That is an exact copy of the original Articles of Incorporation, is it? A. It is.

Q. And the By-Laws attached to it, are they exact copies of the By-Laws of the corporation?

A. They are.

The Court: They were the ones that were in effect during the year 1938, were they? [22]

The Witness: Yes, sir.

Q. (By Mr. Merges): These Articles of Incorporation, do they bear the date of 1937?

A. Yes, December 3, I think is the exact date. They—that was prior—Well, prior to that we were a volunteer organization.

Q. You were, in 1938, operating under this corporate setup? A. That is right.

Q. And you still are? A. We still are.

Mr. Merges: I will offer this in evidence.

Mr. Mather: No objection.

(The document, heretofore marked for identi-

(Testimony of Harry T. Williams.)

fication as Petitioner's Exhibit 1 was received in evidence.)

[Petitioner's Exhibit No. 1 is set out at page 48 of this printed record.]

Q. (By Mr. Merges): Mr. Williams, is there anything that you might like to add in order to inform the Court as to just what the association is?

Mr. Mather: I will object to that question.

The Court: I will sustain the objection.

Mr. Merges: I think that is all. You may inquire.

Cross-Examination

Q. (By Mr. Mather) Do I understand, Mr. Williams, your testimony is that the only merchandise the corporation sold in 1938 was receipt books?

A. Oh, no. No, they had a blanket contract for electric light [23] globes, for instance. They had a blanket contract with the Seattle Hardware Company—that is, a blanket contract covering its member uses. The members, then, would draw upon that stock. That price was broken down—to be exact, during 1938, that price was broken down to—oh, it was approximately 30% below—the association received 36%, and the members received 32—a discount of 32.

Q. What was the extent of the sales which you made in 1938?

A. May I refresh my memory here (witness referring to a paper)? You have it in the other book,

(Testimony of Harry T. Williams.)

Mr. Merges. Do you want it for the full year or monthly?

Mr. Merges: The full year—your sales for the full year.

The Witness: The full sale of supplies was $733.33.

Q. (By Mr. Mather) For the year 1938?

A. Yes, for the year 1938.

Q. Will you give me that figure again?

A. $733.33.

Q. That was all the merchandise that the corporation sold?

A. That was everything in the nature of supplies.

Q. And how much did they receive from advertising in the journal in 1938? A. $2,519.09.

Q. Now, the corporation did file an income tax return in 1938, did it not? [24] A. Yes, sir.

Q. And attached to that return were certain schedules. That return has sales of merchandise of how much? A. $1,352.08.

Q. Is that correct?

A. I beg your pardon. Looking here at cash sales of supplies, accounts receivable, $618.75. That was my error. That makes the total here.

The Court: Now wait a minute. That doesn't mean anything in the record. You have got to distinguish between when you are talking about what the return shows and what you have before you.

The Witness: Well, that was my error. The figure that I gave was the cash sales of supplies.

(Testimony of Harry T. Williams.)

The Court: On the books, do you mean?

The Witness: Yes. Now, under receivable, you find $618.75 which, of course, makes up the difference here.

Q. (By Mr. Mather) All right. Now, what were the gross sales of the corporation for the year 1938?

A. $1352.08.

Q. And those sales in 1938 were made to whom?

A. Members of the Association.

Q. And other than receipt books, what sort of merchandise was sold?

A. Electric light globes. [25]

Q. Anything else?

A. There might have been in that year some items, for instance, some electrical equipment ordered, and in that case there is no reflection here at all. It would be paid for by the members at cost. It was only when the supplies were handled through the office that there was any breakdown at all through the year.

The Court: Now, do you know, in fact, there was something else?

The Witness: Oh, yes, I do. I do know that there were quite considerable items, but no charge went through the association books on it. It wasn't even on our—we just ordered it and delivered to the members, and the members would make their own payments.

Q. (By Mr. Mather) You bought the merchandise, did you not?

(Testimony of Harry T. Williams.)

A. This merchandise, yes.

Q. You bought the merchandise, the total sales of which in the year 1938 represented $1352.08?

A. Yes, sir.

Q. You bought that from wholesale houses, did you not? A. Yes.

Q. And you sold that merchandise to your members? A. Yes.

Q. And the members paid you for it?

A. Yes. [26]

Q. And that is what this $1352.08 represents, is it not? A. That is right.

Q. Now, what was the nature of the advertising that you published in your journal?

A. The nature of the advertising?

Q. Yes.

A. Do you mean in connection with the supplies?

Q. No, in connection with the journal.

A. Oh. It would be the advertising from firms. For instance, it might be the telephone company, the City Light, the Puget Sound Power & Light, furniture firms, or people that dealt with apartment houses.

Q. The journal solicited that advertising from these people, did it? A. Yes.

Q. And the journal, as I understand it, has been published continuously up until 1939?

A. Not continuously.

Q. Well, when did they——

(Testimony of Harry T. Williams.)

A. (Interposing) Spasmodically. Sometimes it would run for—whenever the journal advertising receipts were not sufficient in volume, they would just take the bull by the horns and suspend publication until they did get sufficient advertising to justify publishing it.

Mr. Mather: That is all. [27]

Redirect Examination

Q. (By Mr. Merges) Can you tell us, Mr. Williams, the amount of your purchases in 1938 that were sold to tenants? A. $977.07.

Q. And there is, of course a differential between that and the amount that you received from the tenants for it? A. Yes.

The Court: I wasn't sure whether I understood you correctly, but I think you said "tenants" in both instances. Now, just what did you mean?

Mr. Merges: I mean members of the association. I beg your pardon, your Honor . I ask the clerk, or, rather, the reporter, to make the change. I am so used to talking about tenants in this organization that I don't seem to get over it.

Q. (By Mr. Merges) Will you now tell the Court what was done with this differential?

A. It went into the general income; it went into the general fund of the association.

Q. And has any of this general fund ever been distributed to anyone? A. No, sir.

Q. What do you intend to do with this general fund? I take it you have some surplus there.

(Testimony of Harry T. Williams.)

Mr. Mather: That is objected to as irrelevant and immaterial. [28]

The Court: Sustained.

Q. (By Mr. Merges) What have you done with the general fund to date?

A. We have used it for association activities—for association expenses.

The Court: Such as what?

The Witness: We maintain from the headquarters—we hire help. We have never had sufficient help yet. We try to expand as rapidly as we can—that is, we are looking ahead for the future.

Q. (By Mr. Merges) Where are your headquarters, Mr. Williams?

A. In the Empire Building. 664 Empire Building.

Q. And how many offices do you have there?

A. Four.

Q. Four rooms? A. Four rooms.

Q. And you have items of office equipment such as a typewriter, and so on?

A. Oh, yes. As a matter of fact, the majority of our printed forms, we make ourselves on a duplicator. We make these forms, remember, under the instructions of the members. We are not in any sense of the word—we only make the forms that the members, by their voting in the association, signify that we should make for them.

The Court: Do you mean to say that this fund, in which [29] you put these differentials, as you call them,——

(Testimony of Harry T. Williams.)

The Witness (Interrupting): To our general fund.

The Court: You understand that that general fund is used for the payment of the ordinary expenses of the organization, such as salary, furniture, and fixtures, equipment, and that sort of thing?

The Witness: Yes, sir.

Q. (By Mr. Merges) And you draw a salary as Executive Secretary, do you? A. Surely, I do.

Q. And you have a stenographer and bookkeeper, do you? A. And a field man.

Q. And a field man? A. Yes.

Q. And all those——

A. (Interposing) There are three permanent employees.

Q. And they are all paid out of this——

A. (Interposing) All paid out of——

The Court: Now, wait just a minute. I am going to tell you now not to do that any more. Read that question, Mr. Reporter, and let the question be finished.

(Whereupon, the reporter read as follows:)

"Question: And they are all paid out of this——"

Q. (By Mr. Merges) They are all paid out of this surplus fund?

A. Yes. I can't answer it without—it is not the surplus [30] fund, it is the general fund. It is the general, active fund of the association; there is no special fund.

(Testimony of Harry T. Williams.)

The Court: Is that what you call a fund any different from the moneys that you get from dues?

The Witness: No; it is all together; the dues. It all goes in—we just have one fund—general income.

Q. (By Mr. Merges) Do you mean to state that your dues, the receipts from the sale of these items of personal property and the receipts from the journal have all gone into one general fund?

A. That is right.

Q. And that fund is used to pay the expenses of the office and the salaries of the employees of the association? A. That is right.

The Court: It is accumulating? It is getting larger?

The Witness: Right now it is stationary. It just so happened in 1938 we had just incorporated and came under a labor agreement, which accounted for a step-up in our membership—that is the people who would prefer to handle their labor relations through the association than as individuals. That accounted for a rather marked pick-up in membership. Prior to that, if we had two or three hundred dollars of a balance, we were lucky. Since that time, though, the membership has greatly enlarged, and we run now slightly better than $2,000 of a balance. [31]

The Court: Do you mean there are $2,000 at the end of the year in excess of the amount that you have needed to pay expenses?

The Witness: Yes. At the end of each month or at the end of the year.

(Testimony of Harry T. Williams.)

The Court: And has that amount been expanding? Has that surplus been expanding or not?

The Witness: It has remained fairly stationary. During 1938, it did expand.

The Court: And had it expanded before that time?

The Witness: It has gone up and down. In the time of trouble, for instance, such as during the depression, why, our membership, of course, was decimated.

The Court: You had $2,000 in 1938?

The Witness: No. No, in 1938 we had $1565.

The Court: And how did that compare with earlier years?

The Witness: Earlier years?

The Court: Yes.

The Witness: I have right before me here the —No, I would have to look at the——

The Court: Generally speaking, was the $1500 larger than the year before?

The Witness: Yes, much larger.

The Court: Was that larger than the year before that?

The Witness: That was much—yes, it gradually grew [32] up as we came out of the depression.

The Court: From 1929 on?

The Witness: In 1929 we were about at our maximum then. That was about our high spot prior to this incorporation in 1937, and then we had—I am speaking from memory now, of course. I would

(Testimony of Harry T. Williams.)

have to check on figures, but it would be usually two or three hundred dollars of a balance. If it was any more than that we would——

The Court: But the balance has improved each year, so that each year at the end, you turned a larger balance in the next year than you had before?

The Witness: And in 1938 the balance had grown——

The Court: The balance had grown to be about $1500, and that, in turn, grew to be about $2,000, where it is now?

The Witness: Yes, that is about stationary now. It has about reached our peak.

The Court: And how long has it been stationary?

The Witness: We have, however,—after we discontinued the journal, it was necessary to increase dues, and the dues were increased by practically double.

The Court: That is in 1939?

The Witness: Since 1938, your Honor; and that two thousand dollars now is just stationary, but it is under a greatly increased dues, because our mailing—of course, after we discontinued the journal, there was a great deal more postage and many more [33] letters to be sent out to cover the subject. We couldn't use the journal.

Q. (By Mr. Merger) What is the policy of the association with reference to this surplus? Is it to allow it to grow and grow and grow?

A. No. As I said, the ideal, of course, is to have

(Testimony of Harry T. Williams.)

a cushion which will cover one year's operation, if you can ever obtain that. That is the goal of every trade association secretary. It is like a great many ideals, which is seldom attained.

Q. (By Mr. Mather) You have a cushion now to cover about how long? How long now could you operate under your present surplus?

A. Under our present surplus?

Q. Yes. A. Not to exceed four months.

Mr. Mather: That is all.

Mr. Merges: That is all.

The Court: Stand aside.

(Witness excused.)

Mr. Merges: Call Mr. Miner.

J. MINER

a witness on behalf of the Petitioner was duly sworn and testified as follows:

Direct Examination

Q. (By Mr. Merges) Will you state your name to the Court, [34] please?

A. J. Miner.

Q. What is your profession, Mr. Miner?

A. I am a public accountant.

Q. And what connection in that regard do you have with the Apartment Operators Association?

A. I have been an auditor of the books of that association for a number of years.

Q. And did you prepare a report and audit

(Testimony of J. Miner.)

in 1938 of the Apartment Operators Association?

A. Yes, sir.

Q. Is this report prepared by you?

A. Yes, sir.

Q. Was this taken from the original books and records of the association, made in the regular course of business? A. It was.

Mr. Merges: I will offer this in evidence.

Mr. Mather: It is objected to as not the best evidence; not within any of the issues in the pleadings. There is no question raised with respect to the income of this organization. The only error that is alleged is that the organization is exempt.

Mr. Merges: I would like to show, your Honor, just exactly what the financial setup of this organization is. The amounts that have been expended for various things and the [35] surplus and the expenses of the organization. There is some contention that, for example, that this journal has made a profit; that is, that it is operated for profit, which shows that there was a loss on the journal alone of $899.

The Court: Well, the present objection is that this is not the best evidence, which means that the books from which this was taken are the best evidence.

Mr. Merges: I have the original books, if the Court please, and I can introduce them. However, the original books—the witness testified that this was taken from the original books, and the

(Testimony of J. Miner.)

original books would be rather long for the Court or anyone else to go through; but I have them in court, and I can introduce them. This is merely a short cut.

The Court: The purpose for which it is introduced or offered, Mr. Mather, if you want to, you may cross-examine the witness to see whether it should be received. I don't think it is necessary for us to exclude it because it isn't the best evidence, as long as the books are in the court room.

Mr. Mather: The second part of my objection, if your Honor please, is that it is not in any of the issues raised in any of the pleadings in this case.

The Court: I think the question of exemption, under the statute, as to whether any of the—as to whether there are any of the profits paid to any individual—any private [36] individual, justifies the introduction of evidence as to the finances of the year, in so far as those finances can be properly proven. Now, if you insist upon the books themselves, I should think you would probably have the right to have them; but this might be an easier way to get at them, and let you examine the auditor's report before we exclude them.

Mr. Mather: Very well. I would like to see it.

Q. (By Mr. Mather) Mr. Miner, Exhibit 2 of this document has cash disbursed for the year 1938. Are those figures taken from the books for the year 1938? A. Yes, sir.

(Testimony of J. Miner.)

Q. Did you have anything to do with the preparation of the return for the year 1938?

A. Yes, our office did.

Q. Will you tell me what the difference is between the expenditures shown in the return and the expenditures shown in your audit report?

A. Yes, sir.

Q. What is that difference?

A. The audit report is a statement of cash—actual cash disbursements, including all items of cash disbursed. The statement to which you refer——

The Court: In the return?

The Witness: In the return, is an analysis of the general expenses to be allocated to the departments of the [37] operation.

Q. (By Mr. Mather) Is that taken from the books, too?

A. Yes; it was taken from the books. That is a statement of the expenses to be allocated to the departments. It is a complete exhibit of the cash disbursements.

The Court: Why shouldn't the sum of one be equal to the sum of the other?

The Witness: If you take all of the expenses, they would; but that is only a part of the expenses to be distributed to the various departments. Some of those were returned direct.

The Court: Well, I don't understand what that means. What disbursements are there that are not chargeable to any department?

(Testimony of J. Miner.)

The Witness: For one thing, the purchase of supplies for resale. The actual disbursements for that was $977.07; that is not the expense of any departmental expenses.

The Court: So that would not be shown on the schedule appended to the return?

The Witness: That is right.

Q. (By Mr. Mather) Is that the only item?

A. Well, I don't believe that this item of the expense for printing the journal, $1374.20. That was covered, to a large extent, through advertising, and that was not a departmental expense of the association. [38]

Q. And that is included in your expenditures?

A. Yes, sir.

The Court: But not on the schedule appended to the return?

The Witness: No, sir; not as an expense to the departments.

Q. (By Mr. Mather) Well, now, the schedule attached to the return shows net income for the year ended December 31, 1938, of $941.09. Is that net income as it appears on your books of the company for the year 1938?

A. The 1938 audit report.

Q. Now, if you don't understand the question, I will reframe it; but the question was—— Will you read it, Mr. Reporter?

(The question referred to was read by the reporter.)

(Testimony of J. Miner.)

A. No.

Q. The books don't show that net income of $941.09? A. No, sir.

Q. Do you know where the figure came from, $941.09? A. Not off-hand.

Q. Did you have anything to do with the preparation of that return?

A. Not this return, no.

Q. What return did you have something to do with? A. This one—this audit report.

The Court: You answered the question before as to the [39] return, and by the return, I mean the return, and I don't mean report. You said when you were asked whether you prepared the return, you said, "Our office helped to prepare that return." Now, am I to understand that you, or your office, did not help prepare that?

The Witness: Someone in our office did, your Honor; but I did not, and I cannot answer that question about this return.

Q. (By Mr. Mather) You don't know where the $941.09 does come from; is that right?

A. No, not exactly; but I know what this statement shows.

Mr. Merges: And by, "this statement" you mean the statement of income and disbursements?

The Witness: Yes, sir.

Mr. Mather: That is all.

The Court: What about the offer of the audit report? That is what this examination was conducted about. Do you object to it?

(Testimony of J. Miner.)

Mr. Mather: Well, I won't press my objection with respect to it being the best evidence. I will object to it for the other reasons that I have stated.

The Court: I will overrule the objection. Received.

(The document referred to was marked Petitioner's Exhibit No. 2 and received in evidence.)

[Petitioner's Exhibit No. 2 is set out at page 78 of this printed record.]

Q. (By Mr. Merges) Can you tell me, Mr. Miner, from this [40] report, the net profit, if any, for the year 1938? A. Yes, sir.

Mr. Mather: We object to that, your Honor, as calling for a conclusion of the witness.

The Witness: Now, there are a lot of elements that go into profit.

The Court: The report is in evidence. Why is it necessary to have the witness read what is on the report?

Mr. Merges: I will withdraw the question.

(The witness figuring on the paper.)

The Court: Now, don't do any figuring on that paper.

The Witness: Yes, sir. I will erase it.

The Court: You had better erase it.

(The witness doing as requested.)

Q. (By Mr. Merges) As far as you know, that report presents a picture of the income and dis-

(Testimony of J. Miner.)

bursements of the Operators Association during the year 1938, Mr. Miner?

Mr. Mather: That is objected to as leading.

The Court: Overruled.

Mr. Merges: Will you read the question, please?

(The question referred to was read by the reporter.)

A. This presents a full analysis of the cash receipts and the cash disbursements from the beginning, balance of cash on hand and the net earnings—cash on hand.

Q. Have you, in your experience as auditor for the association [41] ever heard of their distributing any benefits or dividends to their members out of the profits of the——

Mr. Mather: That is objected to as irrelevant and immaterial and hearsay.

The Court: Sustained.

Mr. Merges: I think that will be all.

The Court: Is there anything further from this witness?

Mr. Mather: No cross-examination.

The Court: That is all.

(Witness excused.)

Mr. Merges: Call Donald C. Haas.

DONALD C. HAAS,

a witness on behalf of the Petitioner, was duly sworn and testified as follows:

Direct Examination

Q. (By Mr. Merges) Will you state your name for the record, please? A. Donald C. Haas.

Q. What is your connection with the Apartment Operators Association, if any, Mr. Haas?

A. I am president of the organization.

Q. Do you receive a salary for your work as president? A. I do not.

Q. Who assists you in the management of the corporation; that is, is there a Board of Trustees? [42]

A. There is a Board of Trustees, yes.

Q. What is their function? How often do they meet?

A. They meet regularly once a month for the purpose of auditing the bills and managing the aasociation; and they also meet on special call whenever necessary.

Q. And what persons does this Board of Trustees consist of?

A. Members of the organization.

Q. Do they receive any salary for their services?

A. They do not.

Q. Were you familiar with the affairs of the association in 1938?

A. Yes; I was a trustee then.

Q. As trustee, did you have occasion to ex-

(Testimony of Donald C. Haas.)

amine the books, and were you acquainted with the disbursements made by the association?

A. Yes.

Q. Was there any distribution of profits, or benefits, to members? A. There was not.

Q. Is the association operating now in substantially the same fashion that it did in 1938?

A. It is.

Q. You heard the testimony of Mr. Williams?

A. I did.

Q. Is it true and correct, as far as you know? [43] A. It is.

Mr. Mather: Now, if your Honor please, I object to that question for the reason that I don't know what part of this testimony is being referred to.

Mr. Merges: His entire testimony.

Mr. Mather: I beg your pardon.

Mr. Merges: I am merely trying to shorten this up. I could go through all those things if you like, counsel. I would be very glad to, but I am merely trying to shorten the hearing. If you would like me to ask him the questions that I asked Mr. Williams, or further details of the operation of the association, I would be very pleased to do so.

Mr. Mather: You will have to judge for yourself, counsel.

Q. (By Mr. Merges) What would you say, from your experience and knowledge of the association, Mr. Haas, is the purpose of it?

(Testimony of Donald C. Haas.)

A. The purpose of the Apartment Operators Association is to assist the individual apartment owners and lessees in the better conduct of their business and to make a more successful apartment operation in the city as a group, and to protect the individual apartment owner when necessary; also to give an opportunity for the different members to meet together and discuss their mutual problems, and to work out solutions to them and to advise the membership of tenants, [44] on request by the individual members, who have defrauded or refused to pay, or caused damage to other members in their buildings, and work of that kind; to act as a buffer between the union and themselves in cases of labor arbitration matters.

Q. Incidentally, Mr. Haas, one of the principal functions of your association is to represent independent operators in negotiations with the labor union; is that not right?

A. That is right.

Q. And you negotiated your first agreement in what year? A. 1937.

Q. In June?

A. I believe it was in June, yes.

Q. And do you have meetings with representatives of the labor unions? A. We do.

Q. And would you describe to the Court just what takes place at those meetings, and how frequently they are held, and the purpose of them?

A. We just completed one meeting—one series

(Testimony of Donald C. Haas.)

of meetings that took place—they started in May and just completed here a week ago, in which the contract between us and the Building Service Employees Union was adjusted and modified to take care of the increased cost of living, and certain other matters that have come up that the union didn't feel were being held in a proper manner, and we adjusted them by [45] having meetings regularly with a committee from the union; that is one of the operations. Also, if any individual member, or any member of the union, have a misunderstanding, we have a special committee that handles that difficulty, and it is of very great service to the members.

Q. Do you have a special room in your office for such things as that—and by your office, I mean the association office? A. We do.

Q. And how are controversies handled there between individual members and the union?

A. The individual member is privileged to come to the room. We have a special room for that; and the secretary of the association represents the association, the union represented by the business agent, and the union member is represented by the business agent for the Apartment House Division. The case is heard, on both sides, and if the chief business agent of the union and the secretary of the association can reach a decision on which they are mutually agreed, that settles the case then and there. Their decision is final. But, if they dis-

(Testimony of Donald C. Haas.)

agree, it goes to a larger committee, composed of three members of the union and three members of the association, and they meet and pick an outside individual to make the seventh member, to settle any question that goes beyond the control of the secretary and the chief business agent of the union. Does that answer your question? [46]

Q. Yes. Is any charge made to the individual members for this service?

A. There is no charge.

Q. Have you been able to avoid any picketing or strikes, by these conferences?

A. Only in cases—there has only been picketing in cases when the individual owner would not abide by the decision mutually agreed to between the secretary of the association and the chief business agent of the union. That is, members of the Apartment Association. There has been outside picketing of non-members.

Q. And just how does the association manage the sale of these articles of personal property that we have been talking about, such as rental agreements, and slips, and forms of various kinds?

A. Rental agreements are printed by the association for the members. We have a little machine in the office that does that. We are able to do that for the members much more reasonably than the members could have the forms printed themselves in small bunches outside. We have a plate made, and they are printed just at the cost of the Apartment

(Testimony of Donald C. Haas.)

Association to print them. It is purely a service to members. There is no profit or anything like that made on them. Does that answer your question?

Q. It does. And, what about the journal? [47]

A. The journal was operated on this basis: When this organization was started, we felt we should have some way of getting information to our members, and we couldn't afford to write them all letters about every little matter that came up, and there were numerous things that came to the organization; so we conceived upon the idea of putting out a small publication with enough advertising to pay the cost of its operation, and in order to save mailing out letters, the idea of the journal was brought forth, and it was operated on that basis entirely. It was just as a means of disseminating information.

Q. And the membership determines the amount of dues, does it not?

A. Yes, it does. Of course, the larger the membership, the more the dues.

Q. Now, you don't understand my question. I mean the amount of the dues payable by the members are set and determined by the membership of the association?

A. Oh, absolutely. The amount can be changed whenever—at the will of the organization—the individual members of the organization at any regular meeting. It can be brought up, and I believe it has to go through two or three meetings before it can be finally passed — before it can be definitely changed.

(Testimony of Donald C. Haas.)

Q. And is it the policy of the association to keep these dues [48] just large enough to provide a comfortable surplus to take care of any emergency?

Mr. Mather: That is objected to as leading, if your Honor please. I don't think there is any occasion to lead this witness.

The Court: I think that is true.

Mr. Merges: May I ask to reframe the question, your Honor?

The Court: Yes.

Q. (By Mr. Merges) What is the policy of the association with regard to determining the amount of dues payable by the members?

A. The dues paid by the individual members are large enough to take care of the operating expenses of the organization, plus a small surplus which is built up slowly for any emergency. We suffered greatly during the depression; so we have a little surplus now that would carry us on for a few months if some major crisis should come up; but there is no surplus intended to accumulate; just enough to keep the association going.

Mr. Merges: I think that is all.

Cross-Examination

Q. (By Mr. Mather) How long have you been president of the association?

A. Well, let's see. I was president in 1935 and, let's see: [49] in 1940 and 1941.

Q. Were you not president in 1938?

A. No, I was not president in 1938.

(Testimony of Donald C. Haas.)

Q. Are you familiar with the by-laws of the organization? A. I am, reasonably.

Q. And the matter of dues is fixed in there, is it not?

A. It is, but it can be changed by amendment to the by-laws.

Q. Has it been changed? A. It has.

Q. By minutes of the corporation?

A. Yes. It was changed—It has been changed once since the corporation was incorporated, and once before.

Q. Do you mean that the dues of the corporation were changed before the corporation was incorporated?

A. No, the dues of the association——

Q. Now, I ask you if the dues of the corporation have been changed? A. Yes.

Q. And when were they changed?

A. I believe they were changed — I think the change was completed in 1940 in November or December.

Q. In 1938, what were the dues?

A. A dollar per building per month.

Q. Per member?

A. No; a dollar per building per month. [50]

Q. Now, in 1938, who buys the supplies in the Service Committee?

A. By who buys the supplies in the Service Committee, do you mean the names of the gentlemen?

Q. Yes.

(Testimony of Donald C. Haas.)

A. I don't remember the names of the exact trustees that were on that particular committee.

Q. You had a set committee, did you not?

A. Oh, yes.

Q. And what were their duties?

A. Well, the only duties that the committee had was, if there was a demand for certain type of forms —suppose, a member wanted to put out a certain kind of form, then, it was referred to that committee, and if the committee felt that the organization should purchase that particular form, or print that particular type of form for a particular member, we did. That was the whole thing. If we decided that there would not be enough call for that type of form to bother, or going to the expense of making it, why, we didn't. That is just what that amounted to; that is exactly the duties.

Q. They performed the duties provided for in the Articles of Incorporation, did they not?

A. That was the actual duties they did.

Q. Well, did they fix the price of the merchandise that was disposed of in 1938? [51]

A. Yes, they considered the cost of the form, and they could say, "Well, we can afford to sell this for so much, figuring the printing cost."

The Court: He is not asking you what they can do; he is asking what they did in 1938.

The Witness: I was not a member of that committee; so I can't tell you that exactly.

Mr. Mather: Mr. Clerk, I would like to have this marked for identification as Respondent's Exhibit A.

(Testimony of Donald C. Haas.)

(The excess profits return for 1938 was marked for identification as Respondent's Exhibit A.)

Q. (By Mr. Mather) I hand you, Mr. Haas, what has been marked for identification as Respondent's Exhibit A, and ask you to state what that is.

A. The corporation income excess profits tax return of the Apartment Operators Association.

Q. For what year?

A. For the year 1938.

Mr. Mather: That is all.

Mr. Merges: That is all.

(Witness excused.)

Mr. Merges: I think there is nothing further, your Honor.

The Court: Has the respondent any evidence?

Mr. Mather: We will offer in evidence the income tax [52] return marked for identification as Respondent's Exhibit A.

Mr. Merges: There is no objection.

(The document heretofore marked for identification as Respondent's Exhibit A was received in evidence.)

[Respondent's Exhibit A is set out at page 83 of this printed record.]

The Court: Do you want to file briefs?

Mr. Merges: Yes.

The Court: All right. File them in accordance with the rules.

(Hearing concluded.) [53]

C O P Y

PETITIONER'S EXHIBIT No. 1

DEPARTMENT OF STATE
Olympia

Article No. 86368 office of the Domestic
Secretary of State

I, Ernest N. Hutchinson, Secretary of State of Washington, do hereby certify that

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ARTICLES OF INCORPORATION
OF THE
APARTMENT OPERATORS ASSOCIATION,
OF SEATTLE

a Domestic Corporation of Seattle, Washington, were, on the 3rd day of November A. D. 1937 at 9:55 o'clock A. M., filed for record in this office and now remain on file herein, being duly recorded in Book 209, at page 463-469, Domestic Corporation.

In Testimony Whereof, I have hereunto set my hand and affixed hereto the Seal of the State of Washington.

Done at the Capitol, at Olympia, this 9th day of November, A. D. 1937.

ERNEST N. HUTCHINSON,
Secretary of State.
(Signed) By CHARLES B. REED
Assistant Secretary of State.

[54]

Petitioner's Exhibit No. 1—(Continued)

Articles of Incorporation
of
Apartment Operators Association
of Seattle

We, the undersigned, Arthur Vander Sys, Harry T. Williams, J. E. Wickstrom, Bert Owen and Verna Germain residents and citizens of the State of Washington, do hereby associate ourselves together for the purpose of incorporating the voluntary organization formed in 1924 and known as Apartment Operators Association, by forming a corporation under and pursuant to Chapter 134 the Law of 1907 of the State of Washington and to that end do hereby make, execute and enter into Articles of Incorporation in triplicate certifying as follows to-wit:

I.

The name of the corporation hereby formed shall be "Apartment Operators Association, of Seattle".

II.

The principal place of business shall be City of Seattle, King County, Washington.

III.

The time of existence of this corporation is and shall be fifty (50) years from the date of its incorporation.

IV.

The corporation shall have no capital stock and is limited to memberships in accordance with the provisions of its By-laws. The interest of each in-

Petitioner's Exhibit No. 1—(Continued)

corporator or member shall be equal to that of any other, and no incorporator or member can acquire any interest which will entitle him to any greater voice, vote, authority or interest in the corporation than any other member. [55]

Membership certificates may be issued under the provisions prescribed by the By-laws of the Company. Membership may be terminated by voluntary withdrawal, by expulsion and by death. Losses of membership through any such cause and the incidents thereof shall be governed by the By-laws of the Company.

V.

The objects and purposes for which this corporation are formed are as follows:

(a) To provide a mutual benefit organization not operated for profit, for the purpose of gathering and distributing facts, data, and information relative to the ownership, operation, and general conduct of apartment houses and the apartment house business in general, for the use and benefits of its members and for public dissemination.

(b) To provide a meeting place, office and other facilities which are deemed necessary or desirable in the handling of its affairs and for use and benefit of its members.

(c) To handle goods, wares and merchandise required by its members, and to render service and counsel, and assistance to its members, and generally to assist them in control of their financial and economic interests and stabilization of the industry.

Petitioner's Exhibit No. 1—(Continued)

(d) To own, operate, publish, manage and distribute any publication deemed advisable, and particularly the magazine known as the "Apartment Journal" in accordance with the law governing such publications, and in connection therewith to employ agents to conduct and handle the same sell advertising space therein and to do all things deemed necessary or expedient in connection therewith.

(e) To encourage and assist in the organization of apartment house owners and operators in the State of Washington. [56]

The Board of Trustees who shall manage the affairs of this corporation shall be composed of fifteen (15) persons who shall be members of the association in good standing, and the names of those who shall manage its affairs for two (2) months after the date of filing these Articles of Incorporation are: Arthur Vander Sys, Donald H. Yates, Harry T. Williams, J. E. Wickstrom, Bert Owen, Verna Germain, Addison Shoudy, Mrs. A. J. Clebanck, Donald C. Haas, Joseph L. Carroll, Otto Heggen, Ida E. Feather, August Anderson, R. S. Lipscomb, A. M. Hoffstater, who shall hold office until the date last aforesaid or until their successors are elected and qualify The number of Trustees of this corporation may be increased, diminished or varied to any number not less than five (5) as may be determined by majority vote of all members in good standing at a meeting called for such purpose.

Petitioner's Exhibit No. 1—(Continued)

VII.

This corporation shall have and enjoy all of the powers, rights, and privileges provided under Chapter 134 of the Laws of 1907 and of all general laws not in conflict therewith, and shall have power,

(a) To make, use and alter a corporate seal at its pleasure in such form as prescribed by the By-laws,

(b) To sue and be sued in any court of law,

(c) To purchase, own, hold, convoy and otherwise use and enjoy real and personal property of all kinds, and in connection therewith to acquire, construct and maintain, and operate buildings and equipment deemed necessary or convenient in connection therewith,

(d) To appoint subordinate agents, and officers and employ labor in connection with its affairs and to fix their compensation.

(e) To charge and collect fees, dues, assessments, service and other charges of its members and to sell or forfeit the interests of any member for [57] default in payment of the same,

(f) To make contracts, borrow money, issue notes, bills and any other evidence of indebtedness and to mortgage or otherwise encumber its property to secure the payment of same,

(g) To establish branches in any one or more cities of the State of Washington under such conditions as may be prescribed by its By-laws,

(h) To do any and all things deemed necessary or convenient to carry out its purposes as permit-

Petitioner's Exhibit No. 1—(Continued)

ted by Chapter 134 Law of 1907 and the general law not in conflict therewith,

(i) To enact and enforce By-laws for the governing of this corporation and its branches and to alter and amend same; and also to alter, amend, enlarge or diminish the purposes of this corporation,

(j) To establish, accumulate, and operate a surplus fund from any of its operations, including: Members' fees, charges and dues; and services rendered members and supplies purchased and handled for its members; and to distribute such fund to members in accordance with the provisions of its By-laws.

In Witness Whereof, we have hereunto set our hands in triplicate this 2nd day of November, 1937.

(signed) ARTHUR VANDER SYS,
(signed) HARRY T. WILLIAMS,
(signed) J. E. WICKSTROM,
(signed) BERT OWEN,
(signed) VERNA GERMAIN.

State of Washington,
County of King—ss.

On this 2nd day of November, 1937, before me, the undersigned, a Notary [58] Public in and for the State of Washington, duly commissioned and qualified, personally appeared Arthur Vander Sys, Donald H. Yates, Harry T. Williams, J. E. Wickstrom, Bert Owens Verna Germain, Addison

Petitioner's Exhibit No. 1—(Continued)

Shoudy, Mrs. A. J. Clebanck, Donald C. Haas, Joseph L. Carroll, Otto Heggen, Ida E. Feather, August Anderson, R. S. Lipscomb, A. M. Hoffstater, known to me to be the same persons mentioned in and who subscribed their names to the foregoing instrument and severally acknowledged to me that they executed the same as their free and voluntary set and deed, for the uses and purposes therein set forth.

In Witness Whereof, I have hereunto set my hand and affixed my official seal, the day and year in this certificate first above written.

(signed) FRANKLIN W. WHITE,
Notary Public in and for the State of Washington, residing at Seattle. [59]

APARTMENT OPERATORS ASSOCIATION
of Seattle
(Incorporated)

By-Laws

Article I.

Section 1. The principal purpose is the incorporation under Washington State Laws of the entire voluntary organization founded in 1924 and known as Apartment Operators Association of Seattle, Washington, under authority and direction to make such incorporation ordered by vote of its members at a regular meeting thereof; admitting to membership in such corporation all members of said corporation all assets of said Association subject to all of its liabilities and obligations.

Petitioner's Exhibit No. 1—(Continued)

Section 2. This corporation hereby accepts as its own members, all members in good standing of the said un-incorporated Apartment Operators Association and also accepts as its own and asserts its ownership in and to all property and assets of said Association of every kind and character, and assumes and undertakes, in consideration thereof, all and every obligation and liability in connection therewith, all subject however, to the Articles of Incorporation and the provisions of the By-laws of this corporation.

Article II.

Section 1. The aim and objects of this corporation shall be: To promote interests of its members; their mutual protection; to promote efficiency in the conduct of their business; to eliminate unwise and unfair business practices; to protect its members against unfair or unjust taxes and legislative enactments; to endeavor to procure sound and just legal protection to the apartment industry; to advise and assist the members in the conduct in their own business; to promote [60] standards and ethical business practices; and to assist in the formation of similar associations in other cities of the State of Washington; in order that the apartment business be permanently established on a sound and economic basis. To that end, the objects and powers stated in the Articles of Incorporation are hereby confirmed and adopted as a part of these By-laws.

Petitioner's Exhibit No. 1—(Continued)

Article III.

Membership

Section 1. Any person, firm, or corporation in Seattle and King County who is the owner, lessee, or responsible operator of any building or buildings containing three (3) or more rental units designed for the occupancy of families living separately and independently of each other, and each having separate cooking quarters or facilities, shall be eligible to membership in this Association. Other memberships will be permitted as hereinafter provided. The interest of such full member shall be equal to that of any other, and no member can acquire any interest which will entitle him to any greater voice, vote, authority or interest in the Association than any other member. Only one full membership will be allowed any person, firm or corporation, irrespective of the number of buildings, owned, controlled or operated

Section 2. Associate and Branch membership may be granted under such conditions as may be provided by the Bylaws of the Association; provided however, that Associate members shall have no vote upon any matter coming before the meeting of the Association.

Section 3. Application for membership in the Association must be made in writing and filed with the Secretary on application forms approved by the Board of Trustees. Each such application shall be accompanied by the prescribed fees and not less than one months dues. [61]

Petitioner's Exhibit No. 1—(Continued)

Section 4. Membership shall be evidenced by the official dues receipt adopted by the Board of Trustees. Upon termination of membership by voluntary withdrawal, by death, or by expulsion, all interests and rights of such member in this Association shall immediately terminate and all interest of such member shall revert to the remaining members of the Association, membership being granted upon this express condition.

Section 5. Membership in the Association shall terminate upon the non-payment of dues or any other indebtedness due the Association, for a period of three (3) months from the due date thereof, provided however, that such member may be reinstated by the Board of Trustees in its discretion upon such arrears in dues or other indebtedness being paid in full, together with such penalty as the Board of Trustees may by resolution provide. Upon termination of membership as herein provided, the Executive Secretary shall thereupon notify any such member thereof by mail, and shall report such action to the next meeting of the Board of Trustees.

Section 6. Any member may be expelled for any cause deemed just, by a two-thirds vote of the Board of Trustees present at any regular meeting thereof. Such member shall be given a fair trial and impartial hearing before the Board and shall have the right to appeal to the next regular meeting of members and a majority vote of the members present at such meeting shall be final. Any expelled member may be re-instated by

Petitioner's Exhibit No. 1—(Continued)

the Board in its discretion, upon removal of the objections to membership.

Section 7. All members and officers of the original unincorporated Apartment Operators Association are declared full members of this corporation. All officers elected or appointed and placed in charge of the business and affairs of this corporation shall automatically become full members for such term of office. Election to any office of this corporation shall automatically [62] admit such officer to membership for such term of office. All subject, however, to the provisions of these By-laws.

Article IV.
Membership Dues

Section 1. Full membership dues shall be $1.00 per month per building, regardless of the number of buildings owned, controlled or operated by any such members, such dues to be payable monthly in advance.

Section 2. Associate membership dues and requirement shall be determined by resolution of the Board of Trustees.

Section 3. Branch membership dues, conditions and requirements shall be determined by resolution of the Board of Trustees.

Article V.
Meeting of Members

Section 1. The regular meetings of members of the Association shall be held on the second Thursday of each month at such time and place as may

Petitioner's Exhibit No. 1—(Continued)

be fixed by the notice of such meeting, unless otherwise provided by the By-laws.

Section 2. Special meetings of the members may be called by the President at any time, and shall be called on request by the Board of Trustees or by the Executive Committee; or shall be called by the Secretary upon written request of any three (3) members of the Board of Trustees, or upon written request of Twenty-one (21) members in good standing. Notice of such special meeting stating time and place and the objects thereof must be mailed to each member in good standing not less than three (3) full days prior to such meeting.

Section 3. The annual meeting of members shall be held at the office of the Association or at such other time and place as determined by the Board and fixed by the notice of such meeting. Such meeting shall be held on the second Thursday in the month of January in each year for the purpose of elect- [63] ing a Board of Trustees and the officers of the Association for the ensuing year, and for the transaction of such other business as may be brought before the meeting. Written notice of the annual meeting shall be mailed by the Secretary at least ten (10) days prior to the meeting, to each member in good standing and entitled to vote, at his address as the same appears on the records of the Association. Failure to mail such notice, or any irregularity in such notice, shall not affect the validity of any annual meeting or of any proceedings at such meeting.

Petitioner's Exhibit No. 1—(Continued)

Article VI.

Quorum

A quorum at any annual, regular or special meeting of members of this Association shall consist of not less than One-Tenth (1/10th) of all the members in good standing and entitled to vote.

Article VII.

Voting Power.

Section 1. No member shall have more than one (1) vote regardless of the number of buildings, owned, controlled, operated or represented by that member. No voting by proxy shall be allowed under any circumstances. A member must be in good standing in the Association in order to be entitled to vote, and in case of dispute on this point the record of the member's account with the Association shall govern, subject to review by the Board of Trustees.

Article VIII.

Government

Section 1. The business and property of the Corporation shall be managed and controlled by the Board of Trustees. There shall be Fifteen (15) Trustees each of whom shall be a full member in good standing in the Association which [64] shall be evidenced by paid up dues receipt; they shall be elected annually by ballot at the annual meeting of members and shall hold office for One (1) year, and until their successors are elected and qualify.

Petitioner's Exhibit No. 1—(Continued)

The Trustees shall set only as a Board and the individual Trustee shall have no power as such. From among such Board of Trustees, there shall be elected by ballot of members at such meeting, one as President, one as Vice-President, one as Treasurer and one as Executive Secretary, provided, however, that any two (2) or more such offices may be held by the same Trustee except the offices of President and Secretary. The Board shall fix all compensation of officers and employees.

Section 2. Place of Meeting: The Trustees may hold their meetings, have an office and keep the books of the Association (except as otherwise may be provided by law) at the office of the Association in the City of Seattle, or at such other place or places as the Board may from time to time determine.

Section 3. Regular Meetings: Regular meeting of the Board of Trustees shall be held on the Wednesday preceding the second Thursday in each month at the office of the Association or such other place or places as the Board may determine. The annual meeting of Trustees shall be held immediately after the adjournment of the annual meeting of members. No notice shall be required for any regular meeting of the Board. In case of any regular meeting date falling upon a holiday the time and place of such meeting will be set by the Executive Committee and notice will be sent to each trustee by the Secretary.

Section 4. Special Meetings: Special meetings

Petitioner's Exhibit No. 1—(Continued)

of the Board of Trustees shall be held when called by the President, or by the Executive Committee, or upon request of any three (3) members of the Board in writing addressed to the Secretary. [65]

The Secretary shall give notice of each special meeting by mailing, telephone or telegraphing the same at least Twenty-four hours before the meeting to each Trustee, but such notice may be waived by the Trustees. At any meeting at which every Trustee shall be present, even though without notice, any business may be transacted, and attendance at any such meeting by any Trustee, shall constitute a waiver of notice.

Section 5. Quorum: A majority of the Board of Trustees for the time being in office shall constitute a quorum for the transaction of business, but if at any meeting of the Board there be less than a quorum present, a majority of those present may adjourn the meeting from time to time until a quorum shall be present.

Section 6. Executive Committee: The Executive Committee shall be composed of the stated officers of the Association and the two immediate past presidents of the Association. The President shall be the Chairman and the Executive Secretary shall be the Secretary thereof. During the intervals between the meetings of the Board of Trustees, in emergency, the Executive Committee shall possess and may exercise all the powers of the Board of Trustees in the management and direction of the affairs of the Association in all

Petitioner's Exhibit No. 1—(Continued)

cases in which specific directions shall not have been given by the Board of Trustees. All action by the Executive Committee shall be reported to the Board of Trustees at its next meeting succeeding such action, and shall be subject to revision and authorization by the Board; provided, that no right of third parties shall be affected by any such revision or authorization. Regular minutes of the proceedings of the Executive Committee shall be kept by the Secretary in a separate book provided for that purpose. Vacancies in the Executive Committee shall be filled by the Board of Trustees. A majority of the Committee with the Secretary shall be necessary to constitute a quorum, and in every case [66] the affirmative vote of a majority of the members shall be necessary for the passage of any resolution. The Executive Committee may act by written resolution of a quorum thereof, attested by the Secretary although not formally convened; it shall fix its own rules of procedure and shall meet as provided by such rules, or by resolution of the Board, and it shall also meet at the call of its Chairman or of any member of the Committee.

Section 7. All matters affecting the welfare of the Association shall be presented to the Board of Trustees for consideration and determination, after which they will be reported to a regular meeting of members of the Association.

Section 8. In the event that the Board of Trustees shall fail to function, any matter may be

Petitioner's Exhibit No. 1—(Continued)

brought before the Association at any regular meeting of members, or at a special meeting of members duly called for such purpose, and the action taken on such matter at any such meeting of members by two-thirds majority shall be final, except as otherwise provided by the By-laws.

Section 9. The actual conduct of the affairs of the Association shall be vested in its officers subject to control at all times by the Board of Trustees and its Executive Committee.

Section 10. Any member having a grievance against the Association or any officer or member of the Association, shall present the same to the Board of Trustees in writing through the Secretary, or in person, before bringing such matter before any meeting of the members of the Association. Should the Board of Trustees fail to act upon such grievance, then the complaining member may present such grievance before a regular meeting of members and a majority vote of a quorum of members present at such meeting shall decide the issue.

Section 11. No other than members of the Association, or its invited guests, shall have the right of the floor without the unanimous consent of the members present at any regular meeting of the Association. [67]

Section 12. The Board of Trustees may delegate from time to time to suitable committees any duties that are required to be executed during the intervals between the meetings of the Board, and such committees shall report to the Board of Trustees when and as required.

Petitioner's Exhibit No. 1—(Continued)

Article IX.

Officers.

Section 1. The officers of this Association shall be; a President, Vice President, Treasurer, Executive Secretary, and such other officers as shall from time to time be provided for by resolution of the Board of Trustees. A person not a Trustee shall not be eligible to hold the office of President, Vice-President, Treasurer or Secretary. All other officers may be chosen either from within or without the Board of Trustees. Such other officers shall be elected at the first meeting of the Board of Trustees after the annual election of Trustees by the members; and shall hold office for one (1) year and until their respective successors shall have been duly elected.

Article X.

Election of Trustees and Officers.

Section 1. Nomination of members as candidates for election as Trustees and officers of the Association shall be made at the regular meeting of the Association held in December of each year.

Section 2. Member candidates nominated shall be voted upon by ballot of the members present at the regular annual meeting held in January of each year.

Section 3. The candidate receiving the highest number of votes for the respective offices for which they were nominated shall be duly elected and shall qualify by being in good standing on the

Petitioner's Exhibit No. 1—(Continued)

books of the Association, and taking the oath of office. [68]

Section 4. Any member of the Association in good standing shall be eligible for nomination and election as a Trustee or officer of the Association.

Section 5. A nominating committee consisting of five members shall be appointed from those present at the regular November meeting in each year, to make recommendations for member nominations at the December meeting of the same year. The committee's recommendations shall be placed before the regular December meeting for the guidance of the members, but shall not restrict the right of members to make additional nominations as they see fit.

Article XI.

Vacancies

Section 1. A vacancy in any elective office shall be filled by a majority vote of the Board of Trustees at any regular meeting; the Trustee or officer so elected to hold office during the unexpired term of the vacancy so filled.

Section 2. The absence of any Trustee or officer from Three (3) consecutive regular monthly meetings of the Board of Trustees shall constitute a vacancy, unless such absence has been sanctioned by the Board, or inability to attend has been reported to the Secretary.

Section 3. Any Trustee or officer may be removed for cause deemed just by two-thirds vote of the Board at any regular, or special meeting called

Petitioner's Exhibit No. 1—(Continued)

for that purpose, or by two-thirds vote of the members at any regular meeting thereof.

Article XII.

Powers and Duties of Officers

Section 1. President: The President shall preside at all meetings of members of the Association and of the Board of Trustees and shall have [69] general supervision over the business and affairs of the Association. He shall appoint all standing committees and such special committees as may be necessary from time to time. He shall fill any vacancies occurring in such committees. He shall sign with the Secretary all official documents authorized by the Board of Trustees of the Association and shall counter sign all checks issued by the Treasurer drawn against Association funds in payment of bills authorized by the Board of Trustees and approved by the Auditing Committee. He shall from time to time make such reports of the affairs of the Company as the Board of Trustees may require and shall annually present a report of the preceding years business to the annual meeting of members. He shall do and perform such other duties as may be from time to time assigned to him by the Board of Trustees.

Section 2. Vice-President: The Vice-President shall possess the power and shall perform the duties of President in his absence or disability. He shall do and perform such other duties as may from time to time be assigned to him by the Board of Trustees.

Petitioner's Exhibit No. 1—(Continued)

Section 3. Executive Secretary: The Executive Secretary shall keep the minutes of all meetings of the Board of Trustees and the minutes of all meetings of its Executive Committee and the minutes of all meetings of the members. He shall attend to giving and serving of all notices of the Association. He shall sign with the President in the name of the Company all contracts and other documents authorized by the Board of Trustees, and when so ordered by the Board of Trustees he shall affix the seal of the Association thereto. He shall sign or attest all receipts for membership fees, dues and other charges and shall keep a record of members showing their current monthly standing. He shall have charge of the Association seal and of the minute boo*k* and of such other books and papers as the Board of Trustees may direct. He shall in general perform all the duties incident to the office of Secretary, subject [70] to the control of the Board of Trustees, and shall be charged with the actual management and conduct of the office of the Association and of the services rendered to members. He shall do and perform such other duties as may from time to time be assigned to him by the Board of Trustees.

Section 4. Treasurer: The Treasurer shall have the custody of all funds and securities of the Association which may come into his hands; he shall be custodian of all the property and assets of the corporation subject to the control and order of the Board of Trustees; when necessary or proper

Petitioner's Exhibit No. 1—(Continued)

he may endorse on behalf of the Association for collection checks, notes, and other obligations and shall deposit the same to the credit of the Association in such bank or banks or depositary as the Board of Trustees may designate. He shall sign with the President all checks against the Association funds drawn in payment of bills authorized by the Board of Trustees and approved by the Auditing Committee. He shall receive all monies due the Association and issue official receipts therefore. He shall make a monthly report of receipts and expenditures and shall prepare a semi-annual statement of all receipts and disbursements on January 1st and July 1st of each year. He shall perform all acts usually incident to the position of Treasurer, and shall perform such other duties as may from time to time be assigned to him by the Board of Trustees, and shall give a bond as required by the Board of Trustees.

Section 5. Committees: When so directed by the Board, Standing Committees shall be appointed by the President to serve for the same length of time as the regularly elected officers and shall be as follows: [71]

(a) Legislative Committee: This committee shall consist of three (3) members, whose duty it shall be to keep in touch with the legislative bodies of the City, County and State in order that the best interests of the members and the apartment industry be properly protected. All matters pertaining to legislative functions, coming be-

Petitioner's Exhibit No. 1—(Continued)

fore meetings of the Association, shall be referred to this Committee before action is taken, and the Committee shall report to the Board of Trustees the results of its deliberations, and such reports shall be acted upon immediately.

(b) Membership Committee: This Committee shall consist of three (3) members whose duty it shall be to investigate all applications for membership in the Association that may be placed in its hands by the Secretary and report their findings to the regular meeting of the Association. This Committee shall devise ways and means of increasing the membership of the Association and present all such proposals to the Board of Trustees.

(c) Ethics and Grievance Committee: This Committee shall consist of three (3) members whose duty it shall be to propose standard of ethics and of business practices as a guide for the members and the business of the Association in general. This committee shall also act as an intermediary in all matters of dispute between the members, or between the members and the Association, and all such matter shall be referred to it for its recommendation.

(d) Program and Publicity Committee: This committee shall consist of three (3) members whose duty it shall be to arrange programs for the monthly meetings of the Association which will be of maximum interest and benefit to the members, and to secure publicity for the Association and its work in behalf of the apartment industry. This com-

Petitioner's Exhibit No. 1—(Continued)

mittee shall have general supervision over all publications, circulars and forms issued by the Association.

(e) Rental Committee: This Committee shall consist of three (3) members whose duty it shall be to keep in touch with the rental situation so that the [72] members may be kept advised of the true condition as to vacancies, rentals, the trend of supply and demand and all such information as may be of value to the Association in rendering accurate service to its members.

(f) Ways and Means Committee: The President shall appoint a Committee of five (5) members either within or without the Board of Trustees as a ways and means committee. Such committee shall have and exercise all the provisions and powers usually exercised by such a committee and not inconsistent with powers conferred by these By-laws.

(g) Auditing Committee: A committee of three (3) members of the Board shall be designated by the President at each regular meeting to audit the current accounts presented at such monthly meeting before the same are approved and paid. The President shall also appoint an auditing committee of three (3) members of the Board who shall audit and verify the accounts of the Secretary and Treasurer for the purposes of the semi-annual report of such officers required to be made January 1st and July 1st of each year.

(h) Supplies and Services Committee: This

Petitioner's Exhibit No. 1—(Continued)

committee shall consist of three (3) members, either within or without the Board of Trustees, to supervise supplies furnished or services rendered to members, and to fix the price thereof, subject to the approval of the Board.

(i) The President and the Executive Secretary shall be ex-officio members of all committees appointed or created when not specifically named therein.

Article XIII.
Official Publication

Section 1. The official publication of this Association is and shall be "Apartment Journal" which is hereby accepted, taken, and declared to be owned, operated and published by this Association and distributed [73] to the members in good standing from time to time and no member can obtain any equity, interest or right therein extending beyond his membership as provided in these By-laws.

Section 2. This publication shall be controlled and managed by the Board of Trustees of this Association under the direct management of the Executive Secretary, titled Managing Editor, assisted by such associate editors as may be from time to time appointed by the President and approved by the Board of Trustees.

Section 3. The Managing Editor with the approval of the President is authorized to employ all additional labor and incur all additional expense incident to publications, mailing and delivery to

Petitioner's Exhibit No. 1—(Continued)

each member monthly a copy of such publications, all subject to the approval of the Board of Trustees.

Article XIV.
Rules of Order

Section 1. Robert's Rules of Order shall govern all meetings of the Association in all cases where they are applicable and in which they do not conflict with the By-laws of the Association.

Section 2. Order of Business: The order of business at any regular or special meetings of members or of the Board of Trustees of the Association shall be as follows:

1. Call meeting to order.
2. Roll call
3. Reading of minutes
4. Communications
5. Reports of officers
6. Reports of standing committees
7. Reports of special committees
8. Unfinished business
9. New business
10. Good of the Association
11. Adjournment [74]

Article XV.
Supplies and Services

Section 1. The Board of Trustees shall have power to authorize the purchase and to otherwise acquire any and all kinds of supplies, goods, wares, and merchandise used or useful by its members in

Petitioner's Exhibit No. 1—(Continued)

connection with their business, consolidating such purchases in their discretion in quantity purchases, in harmony with members' requirements, or orders and withdrawals therefrom, for the purpose of obtaining wholesale prices and reductions; and to dispose of, handle, transport, store, warehouse, sell and deliver same to the members of this Association as required by them; and to fix the price thereof and charge and collect of such member such cost of same plus a service charge or fee for so handling the same; and to set aside any profits derived therefrom in a surplus fund to be established by resolution of the Board of Trustees.

Section 2. The Association will employ and furnish to its members the services of individuals for apartment shopping, and any other service for which there is deemed a general or pressing demand, at the actual cost of such service plus a service charge therefor to be fixed by resolution of the Board of Trustees. All monies received shall be deposited to the credit of the Association in such bank or other depositary designated by the Board.

Section 3. Payments shall be made by checks, or check vouchers, all of which shall be signed by the officer or officers of the company as provided by the By-laws and in the absence of such By-laws the Board of Trustees shall by resolution direct what officers are authorized to sign and countersign checks or vouchers. Bills receivable, drafts and other evidence of indebtedness to the company

Petitioner's Exhibit No. 1—(Continued)

shall be endorsed for the purpose of discount or collection by the Treasurer, or such other officer or officers of the company as the Board of [75] Trustees shall from time to time by resolution designate. No bills or notes shall be executed by or on behalf of the company unless the Board of Trustees of the company shall expressly authorize the same.

Article XVI.

Surplus Fund

Section 1. The Board of Trustees shall by resolution establish a surplus fund in a bank or other depositary of its selection and may change such depositary at its discretion. Into this fund shall be paid and deposited all monies and monetary profits received from fees, dues, service charges, journal advertising and from any other source or sources which are not deemed necessary to retain in the commercial banking account of the Association to meet the operating expenses thereof and for working capital. Such surplus fund shall be jointly owned by all of the members of the Association as such in good standing, but such funds shall be subject to the exclusive control, use, disposal and disbursement by the Board of Trustees.

Section 2. In its discretion, the Board of Trustees may use this fund or any part thereof to acquire and establish an office, meeting place, and other facilities for the handling of the business of the Association, and otherwise for the use and

Petitioner's Exhibit No. 1—(Continued)

benefits of its members, and may distribute such fund, or any part thereof, pro-rata to the members of the Association in good standing, contributing to the source of such fund through the purchase of supplies handled or contracted for by the Association.

Article XVII.

Labor Relations

Section 1. Labor Relations Committee: For the purpose of dealing with labor unions and settling labor disputes between the members and their employees, there is hereby created a Labor Relations Committee to be composed of three (3) [76] members elected by the Board of Trustees. Such committee shall meet with the Committee of labor unions for the purpose of arriving at agreements covering uniform practices and standards of hours and wages applicable to the different types of buildings and employment in the apartment industry. Such committee shall also hear all disputes and complaints arising at any time or from time to time between any member and employee. Any and all negotiations and agreement by such committee with any labor union shall be referred to the Board of Trustees and approved by a majority of the members at any meeting, before the same shall become binding on this Association and its members.

Section 2. Labor Representative: The Executive Secretary of this Association shall be and is hereby made the Labor Representative of this Association for its members and shall have and exercise

Petitioner's Exhibit No. 1—(Continued)

all of the functions as such, subject to control by the Labor Relations Committee and the approval of the Board of Trustees.

Article XVIII.
Seal

Section 1. The seal of this corporation shall be circular in form, containing in the circle the words "Apartment Operators Association", and inside the circle the words and figures "Established 1924 Seattle".

Section 2. This seal may be altered or amended or changed at any time or from time to time by resolution of the Board of Trustees.

Article XIX.
Amendments

Section 1. These By-laws may be amended by filing with the Secretary of the Association a copy of the proposed amendment signed by not less than one-tenth (1/10) of the members in good standing, which shall be acted upon [77] by the Board of Trustees at its next regular meeting and referred to the following regular meeting of members of the Association for determination. Upon vote of Two-thirds (2/3) of the members present at such regular meeting, such amendments shall be declared passed the first reading and shall be referred to the next regular meeting of members for final decision and upon receiving a Two-thirds (2/3) vote of all members at such meeting, such amendments shall be adopted.

Petitioner's Exhibit No. 1—(Continued)

Section 2. These By-laws may also be altered or amended by unanimous vote of the Board of Trustees. Such alteration or amendments to be reported to the next succeeding regular meeting of members for approval.

Article XX.

These By-laws and all amendments thereof shall be firmly bound or entered in a special book which shall be provided for such purpose and shall be in custody of the Secretary, and shall be open to the members at all times during business hours.

[Endorsed]: Filed Sep. 8, 1941. [78]

PETITIONER'S EXHIBIT No. 2

[79]

APARTMENT OPERATOR'S ASSOCIATION
REPORT ON AUDIT
DECEMBER 31, 1938

[80]

E. J. MINER
Certified Public Accountant
Central Building
Seattle, Washington

May 8, 1939.

Apartment Operators Association
Seattle, Washington
Gentlemen:

We have completed an audit of your records for the year ended December 31, 1938 and present herewith our report.

We have prepared and submit as part of this report a statement of Cash Receipts and Disbursements for the year ended December 31, 1938.

We audited the cash transactions in detail throughout the year. Bank statements with paid checks, duplicate receipts and vouchers for all disbursements were presented for our inspection. We found these records to be in order. All disbursements have been properly approved by the finance committee.

During November and December of 1937 and in January 1938 one of your salesmen, Mr. A. J. Bessette, made collections for advertising space in your Journal and failed to turn in the funds to your office. Commissions accruing to Mr. Bessette have been applied to the amount of this defalcation and at this date there is a balance remaining of $85.57. Commissions on future collections are expected to be sufficient to balance the above amount

We have made recommendations to your Secretary-Treasurer for changes in the bookkeeping system which we believe will improve your records. We opened a new general ledger and assisted your bookkeeper to balance the accounts for 1939 to date. We will also supervise the work until your bookkeeper is thoroughly familiar with the changes.

Respectfully submitted,

E. J. MINER,

Certified Public Accountant,
(Member, American Institute of Accountants.) [81]

EXHIBIT 1

APARTMENT OPERATOR'S ASSOCIATION
CASH RECEIPTS AND DISBURSEMENTS
YEAR ENDED DECEMBER 31, 1938

Cash Balance, January 1, 1938		$ 1,209.06
Cash Receipts:		
Membership Dues	$ 6,943.00	
Journal Advertising	2,519.09	
Cash Sales of Supplies	733.33 √Sales	
Collection on Supply Accounts Receivable	618.75	10,814.17
		$12,023.23
Cash Disbursed—Exhibit 2		10,457.82
Cash on Hand and in Bank, December 31, 1938		$ 1,565.41
	(Pencil Notation)	1,209.06
	(Pencil Notation)	356.35

Note: There was also Cash in Bank in the amount of $241.00 representing Legislative Fund Assessments collected. During January 1939 a separate bank account was opened for this fund.

[82]

EXHIBIT 2

APARTMENT OPERATOR'S ASSOCIATION
CASH DISBURSED
YEAR ENDED DECEMBER 31, 1938

Rent	$ 660.00
Telephone and Telegraph	413.58
Equipment Purchased	584.74
Office Supplies	48.29
Mailing Cards and Postage	162.79
Printing Journal	1,374.20

Mailing Journal	202.60	
Stationery and Printing	291.70	
Repairs	24.02	
Towel Service	18.00	
Traveling	10.00	
Journal of Commerce	15.00	
Bond Premiums	12.50	
Western Conference Attendance	135.45	
Salaries and Commissions	5,298.26	
Taxes and Licenses	106.58	
Purchase of Supplies for Resale	977.07	—Purch
Shopping Service	17.50	
General Expenses	105.54	
	$10,457.82	

[83]

APARTMENT OPERATOR'S ASSOCIATION
DEPARTMENTAL OPERATIONS
DECEMBER 31, 1938

		Income	Expense	Profit or (Loss)
Association:				
Dues		$6,943.00		
General Expense			$5,074.34	$1,868.66
Journal:				
Advertising		$2,519.09		
Mailing	$ 202.60			
Printing	1,374.20			
General	1,841.62		3,418.42	(899.33)
Supply Merchandise				
Sales		$1,352.08		
Purchases	$ 977.07			
General	987.99		1,965.06	(612.98)
Net Income per Books				$ 356.35

[84]

APARTMENT OPERATOR'S ASSOCIATION
GENERAL EXPENSE
ALLOCATED TO DEPARTMENTS

Equipment	$ 584.74
Office Supplies and Postage	211.08
Rent	660.00
Salaries	5,298.26
Stationery and Printing	291.70
Taxes	106.58
Telephone	413.58
General Expenses	338.01
Total Expenses	$7,903.95

Distributed on Basis of Total Income:

	Income	Percentage	Expense
Association	$ 6,943.00	64.20%	$5,074.34
Journal	2,519.09	23.30	1,841.62
Supply Department	1,352.08	12.50	987.99
	$10,814.17	100.00%	$7,903.95

[Endorsed]: Filed Sept. 8, 1941. [85]

86

Treasury Department — FORM 1120A — Internal Revenue Service

1938 UNITED STATES CORPORATION INCOME AND EXCESS-PROFITS TAX RETURN 1938

For corporations having total receipts of not more than $250,000 and a net income of not more than $25,000 or no net income (except certain corporations specified in Instruction 2)

For Calendar Year 1938

or Fiscal Year beginning _____, 1938, and ended _____, 1939

PRINT PLAINLY CORPORATION'S NAME AND ADDRESS

(Name) _____ (Town) _____

(Street and number) _____

(Post office) _____ (County) _____ (State) _____

Kind of business _____

File Code 57 Serial No. 3-1233 Docket _____ Audited _____ Checked _____ Cash _____ Check _____ M.O. _____ Tax Paid _____

10 106646 1941 A

ADJUSTED NET INCOME COMPUTATION

GROSS INCOME

Item No.		
1.	Gross sales (where inventories are an income-determining factor)	Less returns and allowances $
3.	Less cost of goods sold (from Schedule B-1)	
3.	Gross profit from sales (item 1 minus item 2)	
4.	Gross receipts (where inventories are not an income-determining factor)	$
5.	Less cost of operations (from Schedule B-2)	
6.	Gross profit where inventories are not an income-determining factor (item 4 minus 5)	
7.	Interest on loans, notes, mortgages, bonds, bank deposits, etc. (See Instruction 18-(1))	
8.	Interest on obligations of the United States (from Schedule A, line 16 (a) (4). (See Instruction 18-(2))	
9.	Rents. (See Instruction 19)	
10.	Royalties. (See Instruction 20)	
11.	(a) Capital gain (or loss) (from Schedule C). (If a net loss, do not enter over $2,000)	
	(b) Gain or loss from sale or exchange of property other than capital assets (from Schedule D)	
12.	Dividends (from Schedule E)	
13.	Other income (state nature of income)	
14.	Total income in items 2, and 6 to 13, inclusive	

STATEMENT OF EXEMPTION

This is a non-profit trade associations operating as an exempt voluntary association until its incorporation in 1937 under the 1907 special law of the State of Washington providing for the formation of corporations not formed for profit and providing forfeiture of its right of existence for violation. This association is exempt under Section 101 paragraph 7 and paragraph 12-B of the Revenue Act.

DEDUCTIONS

15.	Compensation of officers (from Schedule F)	
16.	Salaries and wages (not deducted elsewhere)	
17.	Rent. (See Instruction 23)	
18.	Repairs. (See Instruction 24)	
19.	Bad debts (from Schedule G)	
20.	Interest. (See Instruction 25)	
21.	Taxes (from Schedule H). (Do not include Federal excess-profits tax)	
22.	Contributions or gifts paid (from Schedule I)	
23.	Losses by fire, storm, shipwreck, or other casualty or theft. (Submit schedule, see Instruction 28)	
24.	Depreciation (from Schedule J)	
25.	Depletion of mines, oil and gas wells, timber, etc. (Submit schedule, see Instruction 31)	
26.	Other deductions authorized by law (from Schedule K)	
27.	Total deductions in items 15 to 26, inclusive	
28.	Net income for excess-profits tax computation (Item 14 minus item 27)	$ 9HI 09
29.	Less: Federal excess-profits tax. (See Instruction 26)	
30.	Net income (item 28 minus item 29)	$ 9HI 09
31.	Less: Interest on obligations of the United States (item 8, above)	
32.	Adjusted net income (item 30 minus item 31)	$ 9HI 09

EXCESS-PROFITS TAX COMPUTATION (See Instruction 34)

		Column 1	Col. 2 Rate	Column 3 Amount of Tax
28.	Net income for excess-profits tax computation (Item 28, above)	$ 9HI 09		
34.	Value of capital stock as declared in your capital stock tax return for the year ended June 30, 1938 (or for year ended June 30, 1939, if your income tax fiscal year began in 1938 and ended on or after July 31, 1939)	$ No value		
35.	10 percent of Item 34	None		
36.	Dividends received credit (85 percent of col. 2, Schedule E, but not in excess of 85 percent of Item 33, above)	$ 9HI 09		
37.	Balance subject to excess-profits tax (Item 28 minus total of Items 35 and 36)	$ 9HI 09		$ 112 93
38.	Amount taxable at 6 percent (5 percent of Item 34, but not more than Item 37), and tax			
39.	Balance taxable at 12 percent (Item 37 minus Item 38, col. 1), and tax			
40.	Total excess-profits tax (total of Item 38, col. 3, and Item 39, col. 3)			$ 112 93

INCOME TAX COMPUTATION

	CORPORATIONS WITH NET INCOME OF NOT MORE THAN $25,000. (See Instruction 33)			
41.	Adjusted net income (Item 32, above)	$ 9HI 09		
42.	Dividends received credit (85 % of col. 2, Schedule E, but not in excess of 85 % of Item 41, above)	$ None		
43.	Balance subject to income tax (Item 41 minus Item 42)	$ 9HI 09		
44.	Portion of Item 43 (not in excess of $5,000); and tax at 12½ percent	$ 9HI 09	12½%	$ 117 14
45.	Portion of Item 43 (in excess of $5,000 and not in excess of $20,000); and tax at 14%		14%	
46.	Portion of Item 43 (in excess of $20,000); and tax at 16 percent		16%	
47.	Total income tax (total tax in col. 3 of Items 44, 45, and 46)			$ 117 14
48.	Less: Credit for income taxes paid to foreign country or U.S. possession by a domestic corporation. (See Instructions 36)			None
49.	Balance of income tax (Item 47 minus Item 48)			$ 117 14
50.	Excess-profits tax (Item 40, above)			$ 112 93
51.	Total tax due (Item 49 plus Item 50)			$ 230 07

NOTE.—One form marked "DUPLICATE COPY" must be filed with the original return (but will be executed if duplicate copy is not filed).

A-1

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[Printer's Note—Respondent's Exhibit A continued containing Schedules A to E, inclusive. A printed form not filled in.]

Schedule F.—COMPENSATION OF OFFICERS. (See Instruction 22)

1. Name and Address of Officer	2. Official Title	3. Time Devoted To Business	Percentage of Corporation's Stock Owned— 4. Common	5. Preferred	6. Amount of Compensation
					$
Total Compensation of Officers. (Enter as item 15, page 1)					$

NOTE.—Schedule H-1 (IN DUPLICATE) also must be filed with this return if compensation in excess of $75,000 was paid to any officer or employee.

Schedule G.—BAD DEBTS. (See Instruction 25) (See note 1)

1. Taxable Year	2. Net Income Reported	3. Debts on Account	4. Bad Debts Charged Off by Corporation If No Reserve is Carried on Books (See note 2)	If Corporation Carries a Reserve— 5. Gross Amount Added to Reserve	6. Amount Charged Against Reserve
1934	$	$	$	$	$
1935					
1936					
1937					
1938. (See note 4)					

1. Check whether deduction claimed represents worthless debts charged off ☐, or is an addition to a reserve ☐.
2. In addition to the data required above, corporations claiming deductions on other than a reserve basis must submit the information specified in Instruction 26.
3. Not including securities which are capital assets ascertained to be worthless and charged off within the taxable year, which should be reported in Schedule C.

Schedule H.—TAXES. (See Instruction 27)

Nature	Amount
	$
Total. (Enter as item 21, page 1)	$

Schedule I.—CONTRIBUTIONS OR GIFTS PAID. (See Instruction 28)

Name and Address of Organization	Amount
	$
Total. (Enter as item 22, page 1, subject to 5 percent limitation). (See Instruction 28)	$

Schedule J.—DEPRECIATION. (See Instruction 30)

1. Kind of Property (If buildings, state material of which constructed)	2. Date Acquired	3. Cost or Other Basis	4. Assets Fully Depreciated to Date of End of Year	5. Depreciation Allowed (or allowable) in Prior Years	6. Remaining Cost or Other Basis to be Recovered	7. Estimated Life Used in Accounting for Depreciation	8. Estimated Remaining Life From Beginning of Year	9. Depreciation Allowable This Year
		$	$	$	$			$
Total. (Enter as item 24, page 1)								$

Schedule K.—OTHER DEDUCTIONS. (See Instruction 32)

Schedule L.—DISTRIBUTIONS TO STOCKHOLDERS

Distributions Out of Earnings or Profits of the Taxable Year or Out of Earnings or Profits Accumulated Since February 28, 1913 (Indicate dates paid)	1. Taxable Distributions	2. Nontaxable Distributions
1. Cash	$	xxxxxxxxxx
2. Assets other than cash or the corporation's own securities: (See notes 1 and 5.) (Indicate nature of assets.)		
		xxxxxxxx
3. Treasury stock. (See notes 1 and 5)		$
4. Obligations of the corporation (bonds, notes, script, etc.). (See notes 3 and 5)		xxxxxxxx
5. Common stock of the corporation distributed to holders of common stock. (See notes 3 and 5)	xxxxxxxx	$
6. Preferred stock of the corporation distributed to holders of common stock. (See notes 3, 4, and 5)	$	
7. Common stock of the corporation distributed to holders of preferred stock. (See notes 3, 4, and 5)		
8. Preferred stock of the corporation distributed to holders of preferred stock. (See notes 3, 4, and 5)		
9. Optional—Medium of payment elected by stockholders:		
(a) Cash		xxxxxxxx
(b) Common stock. (See notes 3 and 5)		xxxxxxxx
(c) Other. (See note 5.) (Specify nature)		xxxxxxxx
10. Totals of lines 1 to 9	$	$

1. Enter the lesser of the two following amounts determined as of time of distribution: (a) The adjusted basis in the hands of the corporation as provided in section 113 of the Revenue Act of 1938, or (b) the fair market value.
2. Enter the amount of the fair market value at time of distribution.
3. Enter the lesser of the two following amounts determined as of the time of distribution: (a) Par value; or (b) fair market value.
4. Preferred stock for this purpose should be considered as stock which is preferred as to either dividends or assets, irrespective of formal designation.
5. Distributions in the form of rights to purchase assets or subscribe to stock or other obligations of the corporation should be entered in the item applicable to the assets, stocks, or other obligations for which rights were distributed.

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Schedule M — BALANCE SHEETS (See Instruction 14)

	Beginning of taxable year	End of taxable year
Cash		
2 Notes and accounts receivable		
Less reserve for bad debts		
3 Inventories		
(a) Raw materials		
(b) Work in process		
(c) Finished goods		
(d) Supplies		
4 Investments (See Instruction 15)		
(a) Obligations of a State, Territory, or political subdivision thereof, or the District of Columbia, or United States possessions		
(b) Obligations of the United States		
(c) Obligations of instrumentalities of the United States		
5 Other investments (itemize)		
6 Capital assets		
(a) Depreciable assets (itemize)		
Total depreciable assets		
Less reserve for depreciation		
(b) Depletable assets		
Less reserve for depletion		
(c) Land		
7 Other assets (itemize)		
8 Total Assets		
LIABILITIES		
9 Accounts payable		
10 Bonds, notes, and mortgages payable:		
(a) With original maturity of less than 1 year		
(b) With original maturity of 1 year or more		
11 Accrued expenses (itemize)		
12 Other liabilities (itemize)		
13 Surplus reserves (itemize)		
14 Capital stock:		
(a) Preferred stock		
(b) Common stock		
15 Paid-in or capital surplus		
16 Earned surplus and undivided profits		
17 Total Liabilities		

QUESTIONS

1. Business classification. (See Instruction 16)

If engaged in more than one of the business classifications indicated in Instruction 16, state on the two lines above the two businesses accounting for the greater part of the total receipts, and the approximate percentage accounted for by each of the two businesses. If engaged in retail trade, also indicate the number of stores as of the end of the taxable year.

2. Date of incorporation 4-1-1937
3. State or country Washington
4. State collector's office where your return for the preceding year was filed Tacoma, Wash.
5. The corporation's books are in care of Jeff Glascock
Located at 664 Puget Bldg. Seattle
6. Is the corporation a personal holding company within the meaning of section 402 of the Revenue Act of 1938? No. If so, an additional return on Form 1120 H must be filed.
7. Is this a consolidated return of railroad corporations? No. If so, procure from the collector of internal revenue for your district Form 851, Affiliations Schedule, which shall be filed in, sworn to, and filed as a part of this return.
8. If this is not a consolidated return of railroad corporations, did you (a) own at any time during the taxable year 50 percent or more of the voting stock of another corporation either domestic or foreign or (b) did any corporation, individual, partnership, trust, or association own at any time during the taxable year 50 percent or more of your voting stock? No. If the answer is "yes," attach separate schedule showing with respect to each: (1) Name and address; (2) percentage of stock owned; (3) date stock was acquired; and (4) the collector's office in which the income tax return of such corporation, individual, partnership, trust or association for the last taxable year was filed.
9. Was the income of this corporation included in a consolidated return for any prior year? No. If so, give name and address of corporation which filed the consolidated return and the last year for which such return was filed
10. Was the corporation in any way an outgrowth, result, continuation, or reorganization of a business or businesses in existence during this or any prior year since December 31, 1917? No. If answer is "yes," give name and address of each predecessor business and the date of the change in entity
Upon such change, were any asset values increased or decreased? If answer is "yes," closing balance sheets of old business and opening balance sheets of new business must be furnished, unless furnished heretofore.
11. Is this return made on the basis of cash receipts and disbursements? Yes If not, describe fully what other basis or method was used in computing net income
12. State whether the inventories at the beginning and end of the taxable year were valued at cost, or cost or market, whichever is lower Cost If other basis is used, describe fully, state why used, and the date inventory was last reconciled with stock
13. Did the corporation make a return of information on Forms 1096 and 1099 (see Instruction 10–(1)) for the calendar year 1938? Yes
14. Did the corporation at any time during the taxable year own directly or indirectly any stock of a foreign corporation? (Answer "yes" or "no") No (If answer is "yes," attach schedule as required by Instruction 13–(2).)

AFFIDAVIT. (See Instruction 7)

We, the undersigned, president (or vice president, or other principal officer) and treasurer (or assistant treasurer, or chief accounting officer) of the corporation for which this return is made, being severally duly sworn, each for himself deposes and says that this return (including any accompanying schedules and statements) has been examined by him and is, to the best of his knowledge and belief, a true, correct and complete return, made in good faith, for the taxable year stated, pursuant to the Revenue Act of 1938 and the Regulations issued thereunder.

Subscribed and sworn to before me this 1st day of April, 1939

NOTARIAL SEAL — (Signature of officer administering oath) — Notary (Title)

CORPORATE SEAL — (President or other principal officer) (State title) — (Treasurer or assistant treasurer or chief accounting officer) (State title)

AFFIDAVIT. (See Instruction 7)

I/we swear (or affirm) that I/we prepared this return for the person named herein and that the return (including any accompanying schedules and statements) is a true, correct, and complete statement of all the information respecting the income tax and/or excess-profits tax liability of the person for whom this return has been prepared of which I/we have any knowledge.

Subscribed and sworn to before me this ... day of ..., 193 .

NOTARIAL SEAL — (Signature of officer administering oath) (Title)

(Signature of person preparing the return)

(Signature of person preparing the return)

(Name of firm or employer, if any)

A4

APARTMENT OPERATORS ASSOCIATION

DEPARTMENTAL OPERATIONS

		Income	Expense	Profit or (Loss)
Association				
Association Dues		$6,943.00		
Mailing Cards and Postage	$ 162.79			
Travel	10.00			
Western Conference Attendance	135.45			
General Expenses	3,333.72		$3,641.96	$3,301.04
Journal				
Advertising		$2,519.09		
Printing	$1,374.20			
Mailing	202.60			
Commission and Salaries	1,818.26			
General Expense	1,209.90		$4,604.96	($2,085.87)
Supply Merchandise				
Sales		$1,352.08		
Purchases	$ 977.07			
General Expenses	649.09		$1,626.16	(274.08)
Net income year ended December 31, 1938 (Entirely from dues)				$ 941.09

[90]

APARTMENT OPERATORS ASSOCIATION

GENERAL EXPENSES

TO BE ALLOCATED TO DEPARTMENTS

Rent	$ 660.00
Telephone and Telegraph	413.58
Office Supplies	48.29
Stationery and Printing	291.70
Repairs	24.02
Towel Service	18.00

General Expenses (Continued)	
Journal of Commerce	15.00
Bond Premium	12.00
Salaries and Commissions	3,480.00
Taxes and Licenses	106.58
Shop Service	17.50
General Expense	105.54
	$5,192.71

Distributed on Basis of Total Income:	
Association	$3,333.72
Journal	1,209.90
Supply Department	649.09
	$5,192.71

[91]

APARTMENT OPERATORS ASSOCIATION

BALANCE SHEET

December 31, 1938

ASSETS

Cash on Hand	$ 10.73
Cash in Bank	1,795.68
Total Assets	$1,806.41

LIABILITIES

Surplus	
Legislative Surplus	$ 241.00
General Surplus	1,565.41
Total Surplus	$1,806.41

[92]

AFFIDAVIT

State of Washington,
County of King—ss.

The undersigned, Harry T. Williams, being first duly sworn on oath deposes and says: That he is the Executive Secretary and Treasurer of Apartment Operators Association (incorporated) of Seattle, Washington, and makes this affidavit for and on its behalf and for no other purpose; that heretofore this affiant has verified and filed with the Collector of Revenue claim of exemption under the Income Tax Laws of the United States; that proof of exemption as specified in Article 101-1 consisting of an affidavit attached to (a) copy of Articles of Incorporation, (b) copy of By-laws of organization, (c) latest financial statement, (d) statement showing the character of the organization, the purposes for which it was organized, its actual activities, the sources of its income and disposition and a showing that none of its income or surplus may inur to the benefit of any member of the Association.

Affiant further states that Apartment Operators Association is a business league composed solely of bona fide owners and operators of apartment houses in the City of Seattle, King County, State of Washington, who have heretofore associated themselves together as a business league in 1924 and that said organization was duly exempted by the Commissioner of Internal Revenue; that in December 1937, said organization incorporated itself under the non-

profit law of the State of Washington being a special act of 1907 entitled "Corporations Not Formed For Profit" Section 3888 and succeeding paragraphs Remington's Revised Statutes; that Section 11 of said Laws of 1907 provides that if such corporations shall engage in any business, trade, etc., for gain, it shall forfeit its rights to exist as a corporation; that Apartment Operators Association never has and does not now operate for gain or profit and is solely an association of persons having common business interest who have associated themselves together for the purpose of promoting such common interest and the improvement of business conditions in the apartment industry, disseminating information among the members and to act as a common purchasing agent for materials and supplies as and when required by the members, and to prepare and make printed forms desirable or useful in connection with the business of the members.

Affiant further states that this association has no capital stock and further affiant saith not.

Dated this 28th day of September 1939 at Seattle, Washington.

HARRY T. WILLIAMS
Harry T. Williams

Subscribed and sworn to before me this 28th day of September, 1939.

R. C. LONG
Notary Public in and for the State of Washington, residing at Seattle. [93]

[Title of Board and Cause.]

FINDINGS OF FACT AND OPINION

Docket No. 106666

Promulgated January 29, 1942

Exemption as a business league is denied a nonprofit corporation which buys supplies for its members and sells them to the members at a price which includes a service charge or fee which is placed in a fund which under its bylaws may be distributed among the members.

Edward E. Merges, Esq., for the petitioner.

T. M. Mather, Esq., for the respondent.

The Commissioner, holding that the petitioner was not exempt from tax, determined deficiencies for 1938 of $107.49 income tax and $103.19 excess profits tax.

FINDINGS OF FACT

The petitioner is a corporation, with principal office at Seattle, Washington. It filed its return in Tacoma. It was organized November 3, 1937, under the laws of the State of Washington relating to nonprofit corporations. It is limited to memberships and has no capital stock. It pays no dividends.

The objects and purposes for which it was formed are stated in its articles of incorporation as follows:

(a) To provide a mutual benefit organization not operated for profit, for the purpose of gathering and distributing facts, data, and information relative to the ownership, operation, and general con-

duct of apartment houses and the apartment house business in general, for the use and benefits of its members and for public dissemination.

(b) To provide a meeting place, office and other facilities which are deemed necessary or desirable in the handling of its affairs and for use and benefit of its members.

(c) To handle goods, wares and merchandise required by its members, and to render service and counsel, and assistance to its members, and generally to assist them in control of their financial and economic interests and stabilization of the industry.

(b) To own, operate, publish, manage and distribute any publication deemed advisable, and particularly the magazine known as the "Apartment Journal" in [94] accordance with the law governing such publications, and in connection therewith to employ agents to conduct and handle the same sell advertising space therein and to do all things deemed necessary or expedient in connection therewith.

(e) To encourage and assist in the organization of apartment house owners and operators in the State of Washington.

Its powers are stated in its articles as follows:

(a) To make, use and alter a corporate seal at its pleasure in such forms as prescribed by the By-laws,

(b) To sue and be sued in any court of law,

(c) To purchase, own, hold, convoy [sic] and otherwise use and enjoy real and personal property of all kinds, and in connection therewith to acquire,

construct and maintain, and operate buildings and equipment deemed necessary or convenient in connection therewith.

(d) To appoint subordinate agents, and officers and employ labor in connection with its affairs and to fix their compensation.

(e) To charge and collect fees, dues, assessments, service and other charges of its members and to sell or forfeit the interests of any member for default in payment of the same,

(f) To make contracts, borrow money, issue notes, bills, and any other evidence of indebtedness and to mortgage or otherwise encumber its property to secure the payment of same.

(g) To establish branches in any one or more cities of the State of Washington under such conditions as may be prescribed by its By-laws.

(h) To do any and all things deemed necessary or convenient to carry out its purposes as permitted by Chapter 134 Law of 1907 and the general law not in conflict therewith,

(i) To enact and enforce By-laws for the governing of this corporation and its branches and to alter and amend same; and also to alter, amend, enlarge or diminish the purposes of this corporation,

(j) To establish, accumulate, and operate a surplus fund from any of its operations, including: Members' fees, charges and dues; and services rendered members and supplies purchased and handled for its members; and to distribute such fund to members in accordance with the provisions of its By-laws.

Its bylaws during the year 1938 contained the following:

ARTICLE II.

Section 1. The aim and objects of this corporation shall be: To promote interests of its members; their mutual protection; to promote efficiency in the conduct of their business; to eliminate unwise and unfair business practices; to protect its members against unfair or unjust taxes and legislative enactments; to endeavor to procure sound and just legal protection to the apartment industry; to advise and assist the members in the conduct in their own business; to promote standards and ethical business practices; and to assist in the formation of similar associations in other cities of the State of Washington; in order that the apartment business be permanently established on a sound and economic basis. To that end, the objects and powers stated in the Articles of Incorporation are hereby confirmed and adopted as a part of these By-laws. [95]

* * * * * * * *

ARTICLE XII.

* * * * * * * *

Section 5. Committees: When so directed by the Board, Standing Committees shall be appointed by the President to serve for the same length of time as the regularly elected officers and shall be as follows:

(a) Legislative Committee: This committee shall

consist of three (3) members, whose duty it shall be to keep in touch with the legislative bodies of the City, County and State in order that the best interests of the members and the apartment industry be properly protected. All matters pertaining to legislative functions, coming before meetings of the Association, shall be referred to this Committee before action is taken, and the Committee shall report to the Board of Trustees the results of its deliberations, and such reports shall be acted upon immediately.

* * * * * * * *

(e) Rental Committee: This Committee shall consist of three (3) members whose duty it shall be to keep in touch with the rental situation so that the members may be kept advised of the true condition as to vacancies, rentals, the trend of supply and demand and all such information as may be of value to the Association in rendering accurate service to its members.

* * * * * * * *

(h) Supplies and Services Committee: This committee shall consist of three (3) members, either within or without the Board of Trustees, to supervise supplies furnished or services rendered to members, and to fix the price thereof, subject to the approval of the Board.

* * * * * * * *

ARTICLE XIII.

Official Publication

Section 1. The official publication of this Association is and shall be "Apartment Journal," which is hereby accepted, taken, and declared to be owned, operated and published by this Association and distributed to the members in good standing from time to time and no member can obtain any equity, interest or right therein extending beyond his membership as provided in these By-laws.

Section 2. This publication shall be controlled and managed by the Board of Trustees of this Association under the direct management of the Executive Secretary, titled Managing Editor, assisted by such associate editors as may be from time to time appointed by the President and approved by the Board of Trustees.

Section 3. The Managing Editor with the approval of the President is authorized to employ all additional labor and incur all additional expense incident to publications, mailing and delivery to each member monthly a copy of such publications, all subject to the approval of the Board of Trustees.

* * * * * * * *

ARTICLE XV.

Supplies and Services

Section 1. The Board of Trustees shall have power to authorize the purchase and to otherwise acquire any and all kinds of supplies, goods, wares,

and mer- [96] chandise used or useful by its members in connection with their business, consolidating such purchases in their discretion in quantity purchases, in harmony with members' requirements, or orders and withdrawals therefrom, for the purpose of obtaining wholesale prices and reductions; and to dispose of, handle, transport, store, warehouse, sell and deliver same to the members of this Association as required by them; and to fix the price thereof and charge and collect of such member such cost of same plus a service charge or fee for so handling the same; and to set aside any profits derived therefrom in a surplus fund to be established by resolution of the Board of Trustees.

Section 2. The Association will employ and furnish to its members the services of individuals for apartment shopping, and any other service for which there is deemed a general or pressing demand, at the actual cost of such service plus a service charge therefor to be fixed by resolution of the Board of Trustees. All monies received shall be deposited to the credit of the Association in such bank or other depositary designated by the Board.

* * * * * * * *

ARTICLE XVI.

Surplus Fund

Section 1. The Board of Trustees shall by resolution establish a surplus fund in a bank or other depositary of its selection and may change such

depositary at its discretion. Into this fund shall be paid and deposited all monies and monetary profits received from fees, dues, service charges, journal advertising and from any other source or sources which are not deemed necessary to retain in the commercial banking account of the Association to meet the operating expenses thereof and for working capital. Such surplus fund shall be jointly owned by all of the members of the Association as such in good standing, but such funds shall be subject to the exclusive control, use, disposal and disbursement by the Board of Trustees.

Section 2. In its discretion, the Board of Trustees may use this fund or any part thereof to acquire and establish an office, meeting place, and other facilities for the handling of the business of the Association, and otherwise for the use and benefits of its members, and may distribute such fund, or any part thereof, pro-rata to the members of the Association in good standing, contributing to the source of such fund through the purchase of supplies handled or contracted for by the Association.

ARTICLE XVII.

Labor Relations

Section 1. Labor Relations Committee: For the purpose of dealing with labor unions and settling labor disputes between the members and their employees, there is hereby created a Labor Relations Committee to be composed of three (3) members elected by the Board of Trustees. Such committee

shall meet with the Committee of labor unions for the purpose of arriving at agreements covering uniform practices and standards of hours and wages applicable to the different types of buildings and employment in the apartment industry. Such committee shall also hear all disputes and complaints arising at any time or from time to time between any member and employee. Any and all negotiations and agreement by such committee with any labor union shall be referred to the Board of Trustees and approved by a majority of the members at any meeting before the same shall become binding on this Association and its members. [97]

Section 2. Labor Representative: The Executive Secretary of this Association shall be and is hereby made the Labor Representative of this Association for its members and shall have and exercise all of the functions as such, subject to control by the Labor Relations Committee and the approval of the Board of Trustees.

Petitioner exercised substantially all the foregoing functions. It acted as a clearing house for information about tenants, about the operation of apartment houses, and about legislation affecting the business; it gave counsel and advice, and did what it could to promote the common welfare of the members. On its own machine, it printed specially designed forms, such as rent receipts and rental agreements for use in its locality and sold them to members at cost, plus a small margin, the price being less than a member would ordinarily pay if he were

independently to have the forms printed. It gets information about prices and buys articles, such as electric light bulbs and other electrical equipment, for its members in larger quantities and at lower unit prices than they would ordinarily pay, and sells them to the members at prices slightly above cost. In 1938 it bought at a 36 percent discount and sold to its members at 32 percent discount. The price does not include any portion of overhead expenses, such expenses, as for rent, furniture, equipment, and salaries, being paid entirely out of dues. In 1938 it published a journal and distributed it among its members. By this means it disseminated information more inexpensively than by letter or pamphlet. The journal carried advertising of supply houses, light and power, and telephone companies; it did not pay for itself, and was discontinued in 1939. It represents members in labor disputes, and negotiations and hearings are held in its rooms.

Petitioner has no purpose or intention of making a profit, but it tries to have a small surplus to assure its continuance. It maintains a general fund comprising all its receipts, including dues and sales and advertising receipts, and from it payment is made of all expenses, such as salaries and equipment. In 1938 the fund grew and then remained stationary.

As shown by its 1938 return, petitioner's gross receipts were $10,814.17, comprised of dues $6,943, journal $2,519.09, and merchandise sales $1,352.08; and its expenses were $9,873.08, comprised of gen-

eral expense $3,641.96, journal $4,604.96, and merchandise purchases and expenses $1,626.16.

OPINION

Sternhagen: The petitioner claims exemption under Revenue Act of 1938, section 101 (7), as a business league not organized for profit and no part of the net earnings of which inures to the benefit of any [98] private shareholder or individual. The claim, we think, was properly denied by the Commissioner. The petitioner's purchase of supplies at a discount and its resale to the members at less than they would otherwise pay is a business operation and its advantage is the sort of profit inuring to the benefit of the members which is preclusive of the statutory exemption. The fact that the corporation was organized under the state laws relating to nonprofit corporations and the offices had no intention to conduct its operations at a profit is less important than its actual operations. Under article XV of the bylaws supplies may be sold to members at a price which includes a service charge or handling fee, the profits from which may be set aside in a surplus fund; and by article XVI the surplus fund may be distributed among the members. Petitioner was a cooperative buying organization, withholding a margin, however small. Such cooperatives are not among the exempt organizations of the statute, as are farmers' cooperatives, which buy supplies and turn them over to members at actual cost plus necessary expenses. Sec. 101 (12).

The determination is sustained. Uniform Printing & Supply Co. v. Commissioner, 33 Fed. (2d) 445; Northwestern Jobbers' Credit Bureau v. Commissioner, 37 Fed. (2d) 880; Produce Exchange Stock Clearing Association, Inc. v. Helvering, 71 Fed. (2d) 142; Retailers Credit Association of Alameda County v. Commissioner, 90 Fed. (2d) 47; Northwestern Municipal Association, Inc. v. United States, 99 Fed. (2d) 460; Park West-Riverside Associates, Inc. v. Helvering, 110 Fed. (2d) 1022; Durham Merchant's Association v. United States, 34 Fed. Supp. 71.

Decision will be entered for the respondent. [99]

Copy

United States Board of Tax Appeals
Washington

Docket No. 106666.

APARTMENT OPERATORS ASSOCIATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

In accordance with the Board's report, promulgated January 29, 1942, it is

Ordered and Decided that there are deficiencies

for 1938 of $107.49 in income tax and $103.19 in excess profits tax.

Entered Jan. 30, 1942.

[Seal] (S) J. E. MURDOCK
Member. [100]

In the United States Circuit Court of Appeals
For the Ninth Circuit

Docket No. 106666

APARTMENT OPERATORS ASSOCIATION,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR REVIEW OF BOARD DECISION IN THE UNITED STATES BOARD OF TAX APPEALS

Petition of the Apartment Operators Association for Review by the Circuit Court of Appeals for the Ninth Circuit of a Decision by the United States Board of Tax Appeals.

Taxpayer, the petitioner in this cause, by Edwards Merges, its counsel, hereby files its petition for review by the Circuit Court of Appeals for the Ninth Circuit, of the decision of the United States Board of Tax Appeals rendered January 29, 1942, 46 BTA #31, determining that the petitioner is not

exempt under the Revenue Act of 1938, Sec. 101 (7), and that it is accordingly liable for Income and Excess Profits taxes for the year 1938, and respectfully shows:

I.

The petitioner is a corporation duly organized and existing under and by virtue of the laws of the State of Washington, with its principal office in Seattle, Washington. The petitioner made return out of which the tax in question arose, to the office of the Collector of Internal Revenue at Tacoma, which is within the Ninth Circuit.

II.

The controversy involves the question of whether or not the petitioner is entitled to exemption under the Revenue Act of 1938 Sec. 101 (7) as a business league not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual. [101]

The petitioner is a corporation organized under the laws of the State of Washington as a non-profit corporation. It was so incorporated on November 3, 1937. Its membership is limited to Apartment owners and/or operators, and it has no capital stock. It pays no dividends, and its purpose is to advance and protect the business interests of its members. The petitioner advises the membership of tenants at the request of individual members without charge. It represents members in negotiations with Unions, and gives them advice about legislation affecting their business, and does generally what it can to

promote the common welfare of its members. It has a mimeographing machine on which it prints rental receipts and agreements, and sells them to members at cost and a small margin. It buys and sells to its members electric light bulbs at prices slightly above cost. It published a journal and distributed it to its members for the purpose of disseminating information regarding apartment operation. The Journal carried some advertising. The petitioner has no purpose or intention of making a profit in its operation and it is maintained through dues. It has a small surplus which has never been distributed to the membership.

The respondent assessed Income and Excess Profits taxes for the year 1938 in the amounts of $107.49 and $103.19 respectively.

III.

The said taxpayer association being aggrieved by the Findings of Fact and Conclusions of Law, and the Opinion of the Board, and by its decision entered pursuant thereto, desires to obtain a review thereof by the Circuit Court of Appeals for the Ninth Circuit.

IV.

The petitioner assigns as error the following acts and omissions of the Board of Tax Appeals:

1. The failure to hold that petitioner is exempt as a business league under the Revenue Act of 1938, Sec. 101 (7). [102]

2. The failure to hold that the petitioner is en-

gaged in a business not ordinarily carried on for profit.

3. The failure to hold that the petitioner's purchase of supplies and re-sale to its members is incidental to the main purpose of its existence.

4. The failure to hold that the petitioner is an organization where the members have a common business interest organized primarily to advance and protect the business interests of its members, and that it is not a cooperative buying organization.

EDWARDS MERGES
Counsel for Petitioner,
1012 Lowman Building,
Seattle, Washington.

(Duly verified.)

[Endorsed]: U.S.B.T.A. Filed Apr. 23, 1942. [103]

Copy

[Title of Circuit Court of Appeals and Cause.]

ACKNOWLEDGMENT OF SERVICE

We hereby acknowledge service of a copy of the Petition for Review of Board Decision in the United States Board of Tax Appeals, and Notice of Filing the same, in the above entitled cause. April 18, 1942.

(S) J. P. WENCHEL-W
Chief Counsel of the Bureau of Internal Revenue, Washington, D. C.

[Endorsed]: U.S.B.T.A. Filed April 23, 1942.[104]

[Title of Circuit Court of Appeals and Cause.]

ASSIGNMENTS OF ERROR

Petitioner assigns as error the following facts and omissions of the Board of Tax Appeal:

1. The failure to hold that petitioner is exempt as a business league under the Revenue Act of 1938, Sec. 101 (7).

2. The failure to hold that the petitioner is engaged in a business not ordinarily carried on for profit.

3. The failure to hold that the petitioner's purchase of supplies and re-sale to its members is incidental to the main purpose of its existence.

4. The failure to hold that the petitioner is an organization where the members have a common business interest organized primarily to advance and protect the business interests of its members, and that it is not a cooperative buying organization.

Dated this 28 day of April, 1942.

EDWARDS MERGES
Attorney for Petitioner.

Service of a copy of the within assignments of error is hereby admitted this 23rd day of June, 1942.

J. P. WENCHEL-W
Chief Counsel, Bureau of Internal Revenue,
Counsel for Respondent on Review.

[Endorsed]: U.S.B.T.A. Filed Jun. 23, 1942. [105]

United States Board of Tax Appeals
Washington

Docket No. 106666

APARTMENT OPERATORS ASSOCIATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

CERTIFICATE OF CLERK TO TRANSCRIPT OF RECORD

I, B. D. Gamble, clerk of the U. S. Board of Tax Appeals, do hereby certify that the foregoing pages, 1 to 106, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Praecipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of the United States Board of Tax Appeals, at Washington, in the District of Columbia, this 1st day of July, 1942.

[Seal] B. D. GAMBLE
Clerk, United States Board of Tax Appeals.

[Endorsed]: No. 10203. United States Circuit Court of Appeals for the Ninth Circuit. Apartment Operators Association, a corporation, Petitioner, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Upon Petition to Review a Decision of the United States Board of Tax Appeals.

Filed July 24, 1942.

PAUL P. O'BRIEN

Clerk of the United States Circuit Court of Appeals for the Ninth Circuit.

In the United States Circuit Court of Appeals
For the Ninth Circuit.
No. 10203

Docket No. 106666.

APARTMENT OPERATORS ASSOCIATION,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

POINTS TO BE RELIED ON UPON APPEAL

Comes now the petitioner, and notes herewith the following points upon which he intends to rely on appeal:

1. That the petitioner is exempt as a business league under the Revenue Act of 1938, Section 101 (7).

2. That the petitioner is engaged in a business not ordinarily carried on for profit.

3. That the petitioner's purchase of supplies and re-sale to its members is incidental to the main purpose of its existence.

4. That the petitioner is an organization in which the members have a common business interest, organized primarily to advance and protect the business interests of its members.

Dated this 5th day of August, 1942.

EDWARDS MERGES
Attorney for Petitioner.

[Endorsed]: Filed Aug. 8, 1942.

[Title of Circuit Court of Appeals and Cause.]

DESIGNATION OF PARTS OF RECORD TO BE PRINTED

Comes now the petitioner, and designates the following portions of the record to be printed:

1. Petition.
2. Answer.
3. Transcript of Hearing.
4. Findings of Fact and Opinion.
5. Decision.
6. Petition for Review.
7. Assignments of Error.

Dated this 5th day of August, 1942.

EDWARDS MERGES
Attorney for Petitioner.

[Endorsed]: Filed Aug. 8, 1942.

No. 10203

IN THE UNITED STATES CIRCUIT COURT OF APPEALS

For the Ninth Circuit

APARTMENT OPERATORS ASSOCIATION,
a corporation, *Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITIONER'S OPENING BRIEF UPON PETITION TO REVIEW DECISION OF THE BOARD OF TAX APPEALS.

EDWARDS MERGES,
JOSIAH THOMAS, and
CLARENCE L. GERE,
Attorneys for Petitioner.

No. 10203

IN THE
UNITED STATES
CIRCUIT COURT OF APPEALS

For the Ninth Circuit

APARTMENT OPERATORS ASSOCIATION,
a corporation, *Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITIONER'S OPENING BRIEF UPON PETITION TO REVIEW DECISION OF THE BOARD OF TAX APPEALS.

EDWARDS MERGES,
JOSIAH THOMAS, and
CLARENCE L. GERE,
Attorneys for Petitioner.

SUBJECT INDEX

TABLE OF CASES

No. 10203

IN THE UNITED STATES CIRCUIT COURT OF APPEALS

For the Ninth Circuit

APARTMENT OPERATORS ASSOCIATION,
a corporation, *Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITIONER'S OPENING BRIEF UPON PETITION TO REVIEW DECISION OF THE BOARD OF TAX APPEALS.

JURISDICTION

This is a proceeding to review a decision of the United States Board of Tax Appeals (46 B. T. A. No. 31) determining that the petitioner is not exempt under the Revenue Act of 1938, Sec. 101 (7), and that it is accordingly liable for income and excess profits taxes for the year 1938.

From respondents determination of proposed deficiency, an appeal was taken to the Board of Tax Appeals under Sec. 272 (a) (1) I.R.C.

Petitioner is a corporation duly organized and existing under and by virtue of the laws of the State of Washington, with its principal office in Seattle, Washington, and filed its income tax return for the year 1938 with the collector of Internal Revenue at Tacoma, Washington, within this Circuit. The decision of the Board was entered January 30, 1942, (Tr. 104-105). This petition for review was filed April 23, 1942 (Tr. 108). This Court has jurisdiction under Sections 1141 and 1142 I. R. C.

STATEMENT OF THE ISSUES

The petitioner presents the following questions of law arising upon the facts as found by the Board of Tax Appeals, or established by the record:

1. Is the petitioner exempt from income tax by virtue of Sec. 101 (7) of the Revenue Act of 1938, which exempts from taxation business leagues . . . . not organized for profit, and no part of the net earnings of which inures to the benefit of any private shareholder or individual?

2. Altho organized as a non profit business league, does the purchase and sale to its members of merchandise, and the publication and distribution to its members of a trade journal, change the corporation to a profit organization?

3. Are dues paid by members to defray expenses of a business league, income within the meaning of the Internal Revenue Statute?

STATEMENT OF FACTS

The petitioner is a non profit organization formed under Section 3888 and subsequent sections of Remington's Revised Statutes of Washington relating to corporations not formed for profit, (Tr. 12). Its articles of incorporation (Tr. 48-54) define its objects and purposes as follows:

> "The objects and purposes for which this corporation are formed are as follows:
>
> "(a) To provide a mutual benefit organization not operated for profit, for the purpose of gathering and distributing facts, data, and information relative to the ownership, operation, and general conduct of apartment houses and the apartment house business in general, for the use and benefits of its members and for public dissemination.
>
> "(b) To provide a meeting place, office and other facilities which are deemed necessary or desirable in the handling of its affairs and for use and benefit of its members.
>
> "(c) To handle goods, wares and merchandise required by its members, and to render service and counsel, and assistance to its members, and generally to assist them in control of their financial and economic interests and stabilization of the industry.
>
> "(d) To own, operate, publish, manage and distribute any publication deemed advisable, and particularly the magazine known as the 'APARTMENT JOURNAL' in accordance with the law governing such publications, and in connection therewith to employ agents to conduct and handle the same, sell advertising space therein, and to do all things deemed necessary or expedient in connection therewith.
>
> "(e) To encourage and assist in the organization of apartment house owners and operators in the State of Washington."

The articles also define in part the powers, rights and privileges of said corporation under the laws of its incorporation as follows:

> (j) To establish, accumulate, and operate a surplus fund from any of its operations, including: Members' fees, charges and dues; and services rendered members and supplies purchased and handled for its members; and to distribute such fund to members in accordance with the provisions of its By-laws.

The trial Examiner in his findings of fact (Tr. 101-103), after setting out the foregoing quotations, including several others, says:

> "Petitioner exercised substantially all the foregoing functions. It acted as a clearing house for information about tenants, about the operation of apartment houses, and about legislation affecting the business; it gave counsel and advice, and did what it could to promote the common welfare of the members. On its own machine, it printed specially designed forms, such as rent receipts and rental agreements for use in its locality and sold them to members at cost, plus a small margin, the price being less than a member would ordinarily pay if he were independently to have the forms printed. It gets information about prices and buys articles, such as electric light bulbs and other electrical equipment, for its members in larger quantities and at lower unit prices than they would ordinarily pay, and sells them to the members at prices slightly above cost. In 1938 it bought at a 36 per cent discount and sold to its members at 32 percent discount. The price does not include any portion of overhead expenses, such expenses, as for rent, furniture, equipment, and salaries, being paid entirely out of dues. In 1938 it published a journal and distributed it among its members. By this means it disseminated information more inexpensively than by letter or pamphlet. The journal carried advertising of supply houses, light and

power, and telephone companies; it did not pay for itself, and was discontinued in 1939. It represents members in labor disputes, and negotiations and hearings are held in its rooms.

"Petitioner has no purpose or intention of making a profit, but it tries to have a small surplus to assure its continuance. It maintains a general fund comprising all its receipts, including dues and sales and advertising receipts, and from it payment is made of all expenses, such as salaries and equipment. In 1938 the fund grew and then remained stationary.

"As shown by its 1938 return, petitioner's gross receipts were $10,814.17, comprised of dues $6,943, journal $2,519.09, and merchandise sales $1,352.08; and its expenses were $9,873.08, comprised of general expense $3,641.96, journal $4,604.96, and merchandise purchases and expenses $1,626.16."

The records of the corporation were analyzed during the proceedings, before the Trial Examiner, after counsel for respondent claimed:

"It is the position of the respondent that the petitioner is engaged in business and in the type of business normally carried on for profit.

"I think the evidence will show that it bought and sold merchandise at a profit; that it published a journal and accepted advertising in that publication.

"Now those are operations that are normally carried on at a profit. They claim a deficiency in that basis." (Tr. 17).

The details of the purposes and operations of the petitioner corporation are found in the testimony of Harry T. Williams (Tr. pp 11-30). These details greatly abbreviated are:

Petitioner incorporated as a non-profit organization; gathered and disseminated information relative to apartment house business, studied legislation, prepared reports of tenants, printed forms peculiar to apartment house operation, aided members in purchasing supplies from dealers, and from time to time published a journal for members, and acquired a surplus fund to act as a "cushion" sufficient to cover operating expenses for a period not to exceed four months.

E. J. Miner, a certified public accountant, prepared an audit and report of petitioner's business for the year 1938. This report is set forth in petitioner's Exhibit No. 2, (Tr. 78-82). Exhibit 1 of this report (Tr. 80) is a summary of receipts and disbursements:

"EXHIBIT 1

Apartment Operator's Association

Cash Receipts and Disbursements

Year Ended December 31, 1938.

Cash Balance, January 1, 1938			$1,209.06
Cash Receipts:			
Membership Dues	$6,943.00		
Journal Advertising	2,519.09		
Cash sales of Supplies	733.33	V Sales	
Collection on Supply Accounts Receivable	618.75		10,814.17
			12,023.23
Cash Disbursed—Exhibit 2			10,456.82
Cash on Hand and in Bank, December 31, 1938			1,565.41
		(Pencil Notation)	1,209.06
		(Pencil Notation)	356.35

Note: There was also Cash in Bank in the amount of $241.00 representing Legislative Fund Assessments collected. During January 1939 a separate bank account was opened for this fund.

Exhibit 2 of this report gives the details of disbursements totaling $10,457.82, and further arranges departmental operations showing a surplus from dues of $1,868.66, and a loss from the journal publication of $899.33, and a loss on the sale of merchandise of $612.98, leaving a net income per books of $356.35. (Tr. 80-81).

The surplus fund on January 1, 1938, amounting to $1,209.06 and on December 31, 1938, amounting to $1,565.41 (Tr. 80), was never distributed according to the testimony of Harry T. Williams, on redirect examination (Tr. 24).

> "Q. And has any of this general fund ever been distributed to anyone?
>
> A. No sir."

The only two items which respondent claimed constituted profit are referred to in the findings of fact, and are summarized in the last six lines thereof as follows:

> "Journal receipts $2,519.09;
>
> Journal expenses $4,604.96;
>
> Merchandise sales, $1,352.08;
>
> Merchandise purchases and expenses, $1,626.16."

SPECIFICATIONS OF ERRORS TO BE URGED

Petitioner assigns the following errors by the Board in its decision:

1. Failure to hold that petitioner is exempt as a business league under the Revenue Act of 1938 Sec. 101 (7).

2. Failure to hold that the petitioner is not engaged in a business ordinarily carried on for profit.

3. Failure to hold that the petitioner's purchase of supplies and re-sale to its members is incidental to the main purpose of its existence.

4. Failure to hold that the petitioner is an organization where the members have a common business interest organized primarily to advance and protect the business interests of its members, and that it is not a cooperative buying organization.

SUMMARY OF THE ARGUMENT

The facts support the findings of fact by the Trial Examiner, that petitioner was organized as a non profit business league. The undisputed facts disclose that petitioner committed no act to change its status to a profit corporation,—in fact, it meticulously carried out its original purposes, and was thus entitled to its exemptions under Sec. 101 (7) of the Revenue Act. The corporation, in fact, made no profit in 1938, and membership dues are not taxable income.

ARGUMENT

A.

Petitioner was organized as a non profit business league, without capital stock, and no part of net earnings inured to any private shareholder or individual.

The Board erred in holding that petitioner was not exempt as a business league within the meaning of the Revenue Act of 1938. The record, we contend, clearly shows that petitioner is a business league not organized for profit and that no part of its net earnings have ever inured to the benefit of any member, and furthermore, there is no intention that that will ever inure in the future for that purpose.

Sec. 101 (7) of said Revenue Act reads as follows:

> "Business leagues, chambers of commerce, real estate boards, or boards of trade, not organized for profit, and no part of the net earnings of which inures to the benefit of any private shareholder or individual."

A Washington corporation organized under the non profit statute is a business league within the meaning of said section.

If the purpose to engage in such a business is only incident or subordinate to the main or principal purpose required by statute, the exemption cannot be denied on the ground that the purpose is to engage in such a business. In the cases cited by the member of the Board of Tax Appeals, in his opinion in support of his decision, the *purpose* to engage in a regular busi-

ness of a kind ordinarily carried on for profit was not incidental to the purpose required by statute.

In determining whether a purpose to engage in a regular business of a kind ordinarily carried on for profit is merely incidental or subordinate, each case must stand on its own facts, and no rigid rules may be established as a gauge.

To entitle a business league to exemption, two conjunctive requirements must be met (1), it must not be organized for profit, and (2), no part of its net earnings must inure to the benefit of any private share holder or individual. If it fails to meet both of these tests, it is not exempt. If it meets them, it is exempt.

Petitioner was organized as a non profit corporation under the Statutes of the State of Washington and so found by the trial examiner. (Tr. 102-103). The pertinent sections of such statute provide:

> "Sec. 3888 PURPOSE. Corporations may be formed under the provisions of this chapter for any lawful purpose except the carrying on a business, trade, avocation or profession for profit."

Under the laws of Washington, the petitioner is in good standing and is functioning according to its Article By-laws and statutes. The corporate set up is exactly in line with the statute. It logically follows that unless the petitioner violates the very statute which breathes life into it, it cannot engage in a profit making enterprise, nor distribute any net earnings to its members. There is no evidence of such violation,—

in fact, the record shows that the petitioner has not in any way violated the statute under which it is formed. The statute specifically contemplates the furnishing of supplies to members of non profit corporations. Section 3893 of said code says in part:

> "The corporation may by its by-laws provide . . . . the charges which may be made for services rendered or supplies furnished the members of the corporation by it. . . ."

The statute also contemplates such things as a surplus fund and the publication of a journal. Section 3893 continues to list functions of non profit corporations that may be provided for as follows:

> " . . . . the formation of a surplus fund and the manner and proportions in which such surplus funds shall be distributed, either upon the order of the corporation or upon its dissolution, and generally all such other matters as may be proper to carry out the purpose for which the corporation was formed."

There is absolutely no evidence that the petitioner was formed for profit or that it has ever distributed either money or goods as dividends among its members. It is clear from the testimony that the petitioner was only a group of apartment operators banded together for the sole purpose of assisting each other to more efficiently operate their buildings. The amount of goods (mostly receipt books and electric light globes) purchased by the petitioner and sold to its members at a slight mark-up, is so small that such purchase and distribution is merely incidental or subordinate to the

purposes permitted by statute. The Journal is clearly the most practical and economical way of disseminating information regarding apartment operation among the members, and the acceptance of advertising to help defray the expense of publication is merely the means of making the dissemination of information as economical as possible.

The respondent contended that the services in the case at bar showed that the petitioner was engaged in business for profit and was accordingly barred from exemption and the Board of Tax Appeals sustained him in his contention. This position is, however, not sustained by the evidence, the Findings of Fact, or by the conclusions drawn from the findings of fact. A Washington Corporation organized under the non profit statute, is a business league within the meaning of Sec. 101 (7) of the Revenue Act, where no part of the net earnings inures to the benefit of any private shareholder or individual. This position we believe is fully sustained by the authorities dealing with the subject.

Crooks v. Kansas City Hay Dealers Association, 37 Fed. (2d) 83

was brought to recover from the Collector of Internal Revenue income tax, for which rebate had been refused. The trial court allowed recovery, and the Collector appealed. In affirming the trial court the Appellate Court said:

> "Was the association organized for profit? The by-laws provide certain charges for specific services

to be performed for the members such as weighing, plugging, and watching cars of hay. Provision is made for the sale of loose hay that may be on the tracks. All of these collections go into a general fund. Out of these things, including assessment of some fines, the association in 1924 had a net profit of $3,211.48, which included an item of interest from bank deposits, and an invested return surplus of some $1,000.00, which it had at that time accumulated. Upon these facts appellant builds its argument that the association is organized for profit.

"It is unquestioned that the fees received from weighing, plugging and watching services have in some years produced a profit to the association, while in other years there has been a deficit . . . . the more fact that an association of this character may receive some income and arrange that income so as to carry on its work is no proof that it is organized for the sake of profit.

"It has been the experience of the association that the fees realized from these services exceeded the costs of the service, and the surplus over and above the amount actually expended to maintain the service, went into the general fund of the association, and was used wholly in furtherance of the objects and purposes thereof, and no part of said fund has inured to the benefit of any member of the association, or any other individual, but such fund must be used solely and exclusively in furtherance of the objects of the association in accordance with its constitution and by laws. In the examination of the Articles of Incorporation and by-laws of the Association, nothing can be found to substantiate any theory that this organization was organized and conducted for profit."

B.

The publication and distribution of a trade journal, and occasional purchase and sale of merchandise, was merely incidental and the corporation in fact made no profit.

Santee Club v. White, Former Collector of Internal Revenue, 87 Fed. (2d) 5

was an action brought to recover income taxes assessed and paid under the Revenue Act. The Santee Club was organized under the Membership Corporation Law of New York, which was not applicable to corporations, "organized for pecuniary profit." One of the objects of the corporation, as set forth in its constitution was: "To raise such plantation, farm and garden products upon real estate owned by the club, as the club may desire, and to sell or otherwise dispose of the same." In the opinion of the Appellate Court affirming the lower court, which allowed recovery, is the following language:

> "The exemptions are accorded to specific corporations, not to specified transactions . . . . In order to be within the exemptions it must appear, as the District Judge said, that the club in question was (1) organized exclusively for pleasure, recreation and other non-profitable purposes; (2) that it had been *operated* exclusively for such purpose; and (3) that no part of its net earnings *inured to the benefit* of its shareholders. . . .
>
> "We think it clear that considering the provisions of the Certificate of Incorporation, and of the constitution of the club, in connection with the Statute under which the club was organized, it is clearly apparent that the club was organized for non profitable purposes. The last clause in the 3d object 'and to sell or otherwise dispose of the same,' which is relied on by the Government, refers, we think, to a disposal of surplus products, not to a purpose of engaging in the business of raising products in a commercial way."

As the the sale of the real estate, the Court held it was incidental to the general purposes of the club, citing in support of its position, *Lederer v. Cadwalader,* 274 Fed. 753, as follows:

> "A single, isolated activity . . . . does not constitute a trade, business, profession, or vocation."

In appeal of *Waynesboro Manufacturers' Association,* 1 B.T.A. 911

the taxpayer claimed exemption from tax under the Revenue Act of 1918, as a "business league . . . . not organized for profit, and no part of the net earnings of which inures to the benefit of any private stockholder or individual." The taxpayer was an unincorporated association. In its constitution is the following provision:

> "This association shall not be conducted for profit, but shall be maintained by fees, subscriptions and savings effected by collective buying; provided that when a working capital of $25,000.00 is accumulated, these fees, etc., shall be reduced so that they shall cover only the running expenses of the association."

In that case, according to the opinion, both parties agreed the taxpayer was a business league, but they did not agree it was one not organized for profit, and no part of the net earnings of which inures to the benefit of any private stockholder or individual, and therefore exempt by the statute. The opinion was written by Honorable John M. Sternhagen, one of the members of the U. S. Board of Tax Appeals, and the member before whom the case at bar was tried, and from whose judgment this appeal was taken.

After citing and quoting from *Trinidad v. Sagrada Orden*, 263 U. S. 578, 68 L. Ed. 458; 44 S. C.L -204, the trial tribunal reversed the Commissioner, saying:

> "Looking at the constitution of the tax payer, it appears not alone from its affirmative statements of purposes and objects, but by an expressed inhibition that it 'shall not be conducted for profit.' It may acquire a working capital of $25,000.00, but this is not the avowed purpose of its creation. Such working capital is only for the purpose of enabling it to fulfill its non profit functions. And the evidence does not contain any facts which would indicate that actually the association was conducted for profit. It had earnings, but the Supreme Court in the *Trinidad* case clearly said that Congress contemplated this, and that net income does not take the organization out of the Statute. We think the tax payer is a business league not organized for profit. . . .
>
> "The second question is as to the destination of the income—whether any part inures to the benefit of any private individual. This is a question of fact to be determined upon evidence . . . . Here, however, the Commissioner agrees that the taxpayer retained for its own use its earnings. No part thereof inured to the benefit of any individual. Thus the statutory qualifications are fully met."

We quote from the syllabus in *King County Insurance Association,* petitioner *v. Commissioner of Internal Revenue,* respondent, 37 B. T. A. 288

which sets forth the facts therein succintly:

> "Petitioner is a 'trade association,' organized under the laws of the State of Washington, as a non profit organization. Its membership is composed of agents of various insurance companies writing fire and liability insurance in King County, Washington. In order to meet a part of overhead

expenses, the members turn over to the association the business of writing policies upon the Port of Seattle, Seattle School District, and King County Hospital, and the Olympic Hotel, which was constructed upon state lands. The dues of the members were thereby reduced. Held, that the petitioner is a business league, exempt from income tax, under Sec. 103 (7) of the Revenue Acts 1928 and 1932.

This proceeding was brought before the Board of Tax Appeals for the redetermination of deficiencies and penalties for delinquency in filing returns. The first question presented therein was whether or not the petitioner was a business league, exempt from income tax.

In its opinion, the Board said:

"There can be no question but that the petitioner qualifies as a business league, exempt from income tax for 1931 and 1933, the taxable years involved in this proceeding, unless it is barred from such exemption by reason of the fact that it acted as agent in writing insurance policies on so-called 'public business.'

"The respondent contends that by reason of this fact, the petitioner engaged in business for profit, and is accordingly barred from exemption. The evidence shows, however, that the members waived their commissions upon this public business in favor of the association, in order to provide additional revenue for the petitioner's expenses and because it was deemed in the public interest that there should be no competition on the part of the members in the writing of policies upon municipally owned properties. The members nevertheless were required to pay dues or advances, which were rebated only in part upon the receipt by the Association of the commission upon the public business."

The decision in *Inland Empire Rural Electrification, Inc., v. Department of Public Service,* 199 Wash. 527; 92 Pac. 528; sustains our contention in the case at bar.

The Inland Empire, etc., was a corporation created under the same statute as the petitioner herein. A group of farmers incorporated it for the purpose of acquiring electrical energy at cost and selling it to its members. The Department of Public Service asserted and exercised jurisdiction over it as though it were a public service corporation. The Supreme Court held it was not under the jurisdiction of the Department of Public Service, and was pursuing its activities strictly in accordance with the act under which it has been created. The Department contended that although created and purporting to operate under that act, it was in fact and law a public service corporation. In holding that said corporation was not under the jurisdiction of the Department of Public Service, the Court said:

> "Respondent was organized under the 1907 act and, so far as the complaint shows, it conducts its business strictly in accordance with the privileges conferred and the limitations prescribed by that act. But more important than that is the controlling factor that it has not dedicated or devoted its facilities to public use, nor has it held itself out as serving, or ready to serve, the general public or any part of it. It does not conduct its operations for gain to itself, or for the profit of investing stockholders, in the sense in which those terms are commonly understood. . . .

> The service, which is supplied only to members, is at cost, since surplus receipts are returned ratable according to the amount of each member's consumption. There is complete identity of interest between the corporate agency supplying the service and the persons who are being served. It is a league of individuals associated together in corporate form for the sole purpose of producing and procuring for themselves a needed service at cost. In short, so far as the record before us indicates, it is not a public service corporation."

A number of cases are cited by the Court in support of its decision. *Terminal Taxicab Company v. Kutz,* **241 U. S. 252**; 60 L. Ed. 984; 36 S. Ct.. 583; is one of them. In that case the question to be decided was whether or not a corporation, organized by its charter to carry passengers and goods by automobile, taxicab and other vehicles, but not to exercise any of the powers of a public service corporation, was a common carrier and within the meaning of the Public Utility Act, and subject to the jurisdiction of the Public Service Commission. Of the company, the Court said:

> "It does busness in the district, and the important thing is what it does, not what its charter says."

In *State ex rel. Silver Lake R. & L. Co. v. Public Service Commission,* 117 Wash. 453; 201 Pac. 765; the Court said:

> "In our opinion, the question of the character of the corporation is one of fact and must be determined by the Courts upon the evidence presened in the record."

In *U. S. v. Brooklyn Terminal,* 249 U. S. 296; 39 Sup. Ct. Rep. 283, 63 L. Ed. 613, the Court said, by Justice Brandeis:

> "We have merely to determine whether Congress, in declaring the Hours of Service Act applicable 'to any common carrier or carriers, their officers, agents and employees, engaged in the transportation of passengers and property by railroad,' made its prohibitions applicable to the terminal, and its employees engaged in the operations were involved. The answer to that question does not depend upon whether its charter declared it to be a common carrier, nor upon whether the State of incorporation considers it such; but upon what it does."

It is noteworthy that there is absolutely no question of good faith or intentional misstatement of fact anywhere in these proceedings, and the Trial Examiner in effect so found.

Reexamination of Exhibit I (Tr. 80) also fully set out on page 6 of this brief, shows actual increase in assets or income for 1938, $356.35, the membership dues accounting for about two-thirds of the receipts.

It is conceded also, and so found by the Trial Examiner, that the journal receipts amounted in round numbers to $2500, and the Journal expense in round numbers $4600. Merchandise sales in round numbers, $1350.00, and merchandise purchases and expenses, $1625. By every rule of mathematics and reason, any surplus must come from the membership dues. Under what theory can these dues be treated as profit? The answer is, obviously, they can not. They were treated

and should be treated merely as accumulated funds for the purpose of carrying on the business league.

As we understand the theory of the Board of Tax Appeals, any surplus *might be* distributed to members, but the fact still remains, *it was not.*

CONCLUSION

For the foregoing reasons, petitioner contends that the Board erred in determining that for purposes of Federal Income Tax for the taxable year 1938, it was not exempt as a business league, not organized for profit and no part of the net earnings of which inures to the benfit of any private shareholder or individual, and that therefore the decision of the Board should be reversed, with directions to allow exemption claim by the petitioner in its return for the taxable year.

Respectfully submitted,

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No. 10203

In the United States Circuit Court of Appeals for the Ninth Circuit

APARTMENT OPERATORS ASSOCIATION,
A CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR THE RESPONDENT

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Special Assistants to the Attorney General.

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CITATIONS

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OPINION BELOW

The opinion of the Board of Tax Appeals (R. 93–104) is reported at 46 B. T. A. 229.

JURISDICTION

This petition for review (R. 105–108) involved federal income and excess profits taxes for the taxable year 1938. On December 16, 1940, the Commissioner of Internal Revenue mailed to the taxpayer notice of a deficiency in the total amount of $210.68. (R. 3–4.) Within ninety days thereafter and on March 17, 1941, the taxpayer filed a petition with the Board of Tax Appeals for a redetermination of the deficiency under

the provisions of Section 272 of the Internal Revenue Code. (R. 1–3.) The decision of the Board of Tax Appeals sustaining the deficiency was entered January 30, 1942. (R. 104–105.) The case is brought to this Court by petition for review filed April 23, 1942 (R. 105–108), pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

QUESTION PRESENTED

A single question is presented—whether the taxpayer was a business league within the provisions of Section 101 (7) of the Revenue Act of 1938 and, accordingly, exempt from income and excess profits taxes during the year 1938.

STATUTE AND REGULATIONS INVOLVED

Revenue Act of 1938, c. 289, 52 Stat. 447:

> SEC. 101. EXEMPTIONS FROM TAX ON CORPORATIONS.
>
> The following organizations shall be exempt from taxation under this title—
>
> * * * * *
>
> (7) Business leagues, chambers of commerce, real-estate boards, or boards of trade, not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual;
>
> * * * * *

Treasury Regulations 101, promulgated under the Revenue Act of 1938:

> ART. 101 (7)–1. *Business leagues, chambers of commerce, real estate boards, and boards of trade.*—A business league is an association of

persons having some common business interest, the purpose of which is to promote such common interest and not to engage in a regular business of a kind ordinarily carried on for profit. It is an organization of the same general class as a chamber of commerce or board of trade. Thus its activities should be directed to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons. An organization whose purpose is to engage in a regular business of a kind ordinarily carried on for profit even though the business is conducted on a cooperative basis or produces only sufficient income to be self-sustaining, is not a business league. An association engaged in furnishing information to prospective investors, to enable them to make sound investments, is not a business league, since its activities do not further any common business interest even though all of its income is devoted to the purpose stated. A stock exchange is not a business league, a chamber of commerce, or a board of trade within the meaning of the law and is not exempt from tax.

STATEMENT

The facts as found by the Board of Tax Appeals (R. 93–103) and as established by the undisputed evidence in brief are as follows:

The taxpayer was formed in 1924 as a voluntary association of apartment owners under the name of Apartment Operators Association. (R. 49.) On November 3, 1937, it was incorporated under the laws of the State of Washington relating to non-profit cor-

porations. Its membership is limited to owners of three or more rental units of a certain classification in Seattle and King County, Washington. (R. 56, 93.) It has no capital stock and it pays no dividends. (R. 93.)

The objects and purposes for which taxpayer was formed are stated in its articles of incorporation, as follows (R. 93–94):

> (a) To provide a mutual benefit organization not operated for profit, for the purpose of gathering and distributing facts, data, and information relative to the ownership, operation, and general conduct of apartment houses and the apartment house business in general, for the use and benefits of its members and for public dissemination.
>
> (b) To provide a meeting place, office and other facilities which are deemed necessary or desirable in the handling of its affairs and for use and benefit of its members.
>
> (c) To handle goods, wares and merchandise required by its members, and to render service and counsel, and assistance to its members, and generally to assist them in control of their financial and economic interests and stabilization of the industry.
>
> (d) To own, operate, publish, manage and distribute any publication deemed advisable, and particularly the magazine known as the "Apartment Journal" in accordance with the law governing such publications, and in connection therewith to employ agents to conduct and handle the same, sell advertising space therein, and do all things deemed necessary or expedient in connection therewith.

(e) To encourage and assist in the organization of apartment house owners and operators in the State of Washington.

The following summary of provisions of articles of the by-laws are illustrative of the functions of the taxpayer as set out in its articles of incorporation:

1. A legislative committee is provided for to keep in touch with legislative bodies of the city, county and state, in order to protect the best interests of the members of the apartment industry. (Art. XII, Sec. 5 (a); R. 96–97.)

2. A rental committee is provided for to keep in touch with the "rental situation so that the members may be kept advised of the true condition as to vacancies, rentals, the trend of supply and demand, and all such information as may be of value to the Association in rendering accurate service to its members." (Art. XII, Sec. 5 (e); R. 97.)

3. A supplies and services committee is provided for to supervise supplies furnished and services rendered to members, and to fix prices thereof, subject to the approval of the board of trustees. (Art. XII, Sec. 5 (h); R. 97.)

4. An official publication of the taxpayer is established and known as "Apartment Journal," to be managed by the board of trustees, under the direct management of the executive secretary to be known as the managing editor. (Art. XIII; R. 98.)

5. It is provided that the board of trustees, which has power to authorize the purchase and otherwise acquire "any and all kinds of supplies, goods, wares, and

merchandise used or useful by its members in connection with their business, consolidating such purchases in their discretion in quantity purchases, in harmony with members' requirements, or orders and withdrawals therefrom, for the purpose of obtaining wholesale prices and reductions; and to dispose of, handle, transport, store, warehouse, sell and deliver same to the members of this Association, as required by them; and to fix the price thereof and charge and collect of such member such cost of same plus a service charge or fee for so handling the same; and to set aside any profits derived therefrom in a surplus fund to be established by resolution of the Board of Trustees." (Art. XV, Sec. 1; R. 98–99.)

6. It is provided that the association will employ and furnish to its members the services of "individuals for apartment shopping, and any other service for which there is deemed a general or pressing demand, at the actual cost of such service plus a service charge therefor to be fixed by resolution of the Board of Trustees." (Art. XV, Sec. 2; R. 99.)

7. It is provided that there shall be a labor relations committee for "the purpose of dealing with labor unions and settling labor disputes between the members and their employees." The committee is to negotiate with labor unions for agreements covering uniform practices and standards of hours and wages applicable to the different types of buildings and employment in the apartment industry. The committee is also to hear disputes and complaints arising between any member and employee. (Art. XVII; R. 100–101.)

The articles of incorporation provide in Section VII (j) that the corporation shall have power (R. 95):

> To establish, accumulate, and operate a surplus fund from any of its operations, including: Members' fees, charges and dues; and services rendered members and supplies purchased and handled for its members; and to distribute such fund to members in accordance with the provisions of its By-laws.

The counterpart of this provision in the by-laws is contained in Article XVI, which provides that the board of trustees by resolution may establish a surplus fund, into which shall be paid and deposited (R. 100)—

> all monies and monetary profits received from fees, dues, service charges, journal advertising and from any other source or sources which are not deemed necessary to retain in the commercial banking account of the Association to meet the operating expenses thereof and for working capital. Such surplus fund shall be jointly owned by all of the members of the Association as such in good standing, but such funds shall be subject to the exclusive control, use, disposal and disbursement by the Board of Trustees.

Section 2 of this article provides (R. 100):

> In its discretion, the Board of Trustees may use this fund or any part thereof to acquire and establish an office, meeting place, and other facilities for the handling of the business of the Association, and otherwise for the use and benefits of its members, and may distribute such fund, or any part thereof, pro-rata to the members of the Association in good standing, con-

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tributing to the source of such fund through the purchase of supplies handled or contracted for by the Association.

The Board of Tax Appeals found that the taxpayer exercised "substantially all the foregoing functions" and specifically enumerated the following (R. 101–102):

1. It acted as a clearing house for information about tenants and about the operation of apartment houses and legislation affecting the business.

2. It gave counsel and advice and did what it could to promote the common welfare of the members.

3. It printed specially designed forms such as rent receipts and rental agreements on its own machine and sold them to members at cost, plus a small margin. The price was less than a member would ordinarily pay if he were to have the forms printed independently.

4. It secured information about prices and bought articles such as electric light bulbs and other electrical equipment in larger quantities and at lower units prices than the members would ordinarily pay, and sold them to the members at prices slightly above cost. In 1938 it bought at a 36% discount and sold to its members at 32%.

5. In 1938 (the taxable year) it published a journal and distributed it among its members. This method of disseminating information was less expensive than by letter or pamphlet. The journal carried advertising of apartment supply houses, light and power and telephone companies. The Board found that the journal did not pay for itself and was discontinued in 1939. The record indicates that an important reason

for discontinuing the journal was the belief that its publication might subject the taxpayer to income tax liability. (R. 16.) While the journal did not pay for itself, as the Board found, it did save the taxpayer a considerable sum of money in the dissemination of information to its members, as indicated by the fact that the dues were greatly increased after the discontinuance of the journal, due to the large increase in postage and the number of letter which were sent by the taxpayer containing information which previously had been contained in the journal. (R. 29.)

6. It represented members in labor disputes, and negotiations and hearings were held in its rooms.

The Board found that the taxpayer has no purpose or intention of making a profit but that it strives to achieve a small surplus to assure its continuance, and that it maintains a general fund comprising receipts from all sources, which include dues, sales and advertising receipts, from which it pays all expenses. During 1938 the fund increased but has remained stationary since. (R. 102.)

The taxpayer's 1938 return indicates gross receipts of $10,814.17, consisting of dues, $6,943, journal, $2,519.09, and merchandise sales, $1,352.08; its expenses were $9,873.08, comprised of general expenses, $3,641.96, journal, $4,604.96, and merchandise purchases and expenses, $1,626.16. (R. 102–103.)

SUMMARY OF ARGUMENT

The settled tests of whether a non-profit trade association is a tax exempt business league are (1) whether the association carries on a regular business of

a kind ordinarily carried on for profit or performs particular services for individual persons, and (2) whether any of the net profits of the organization inure to the benefit of individual members.

The taxpayer here regularly carried on numerous activities of a kind ordinarily carried on for profit or which constituted services for individual persons. These included printing forms, purchasing and reselling supplies, arranging for direct purchases by members at a discount, supplying credit information, supplying an apartment shopping service, settling controversies between individual members and labor unions, and publishing and distributing a journal. Some of these activities are of a kind ordinarily carried on for profit and all of them contained the common factor of service to the taxpayer's members as a convenience or economy in their business. Together they formed the major phases of the taxpayer's operations and carried out a formally announced and continuing object to improve the condition of apartment owners individually. They were not, therefore, incidental. Moreover, the Board of Tax Appeals' various findings concerning the aforesaid specific activities of a non-exempt nature engaged in by the taxpayer together with its failure to find more than one non-exempt activity are findings of fact binding on this Court since they are supported by substantial evidence and are not based on an erroneous rule of law.

Since taxpayer is engaged in a business of a kind normally carried on for profit and in performing services for individual members, it is unnecessary for the

Court to decide whether the net profits inured to the benefit of individual members. The failure of the taxpayer to bring himself within one of the categories, even though he is within the other, defeats exemption. But here the taxpayer is within neither. Net profits inured to the benefit of individual members, since earnings were available for use in advancing the purposes of the association which directly benefit the members individually, and the surplus fund could be distributed to the members at any time.

ARGUMENT

The taxpayer is not exempt from income and excess profits taxes under Section 101 (7) of the Revenue Act of 1938

Section 101 (7) of the Revenue Act of 1938 provides for the exemption from taxation of:

> Business leagues, chambers of commerce, real-estate boards, or boards of trade, not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual;

The taxpayer claims exemption under this section as a business league. (Br. 9.)

The decisions of this and other federal courts make clear that the taxpayer may qualify as an exempt organization only if (1) it is not organized for profit, (2) it is not engaged in a regular business of a kind ordinarily carried on for profit and if it is semi-civic in nature, having for its primary purpose the advancement of the interests of the community or improvement of the conditions and standards of a particular trade or business, rather than the convenience or economic

interests of its members, and (3) its net earnings do not inure to the benefit of its members. *Retailers Credit Ass'n* v. *Commissioner,* 90 F. 2d 47 (C.C.A. 9th); *Northwestern Municipal Ass'n* v. *United States,* 99 F. 2d 460 (C.C.A. 8th); *Uniform Printing & S. Co.* v. *Commissioner,* 33 F. 2d 445 (C.C.A. 7th), certiorari denied, 280 U. S. 591; *Produce Exchange Stock Clearing Ass'n* v. *Helvering,* 71 F. 2d 142 (C.C.A. 2d); *Park West-Riverside Associates, Inc.* v. *Commissioner,* 110 F. 2d 1022 (C.C.A. 2d), affirming *per curiam* unreported memorandum opinion of the Board of Tax Appeals dated June 2, 1939; *Northwestern Jobbers' Credit Bureau* v. *Commissioner,* 37 F. 2d 880 (C.C.A. 8th); *Durham Merchant's Ass'n* v. *United States,* 34 F. Supp. 71 (N.C.). The taxpayer argues, however, that there are but two conjunctive requirements for exemption: (1) it [the taxpayer] "must not be organized for profit," and (2) "no part of its net earnings must inure to the benefit of any private share holder or individual." (Br. 10.) In making this statement counsel has ignored the provisions of Article 101 (7)–1 of Treasury Regulations 101, promulgated under the 1938 Act:

> A business league is an association of persons having some common business interest, the purpose of which is to promote such common interest and not to engage in a regular business of a kind ordinarily carried on for profit. It is an organization of the same general class as a chamber of commerce or board of trade. Thus its activities should be directed to the improvement of business conditions of one or more lines

> of business as distinguished from the performance of particular services for individual persons. An organization whose purpose is to engage in a regular business of a kind ordinarily carried on for profit even though the business is conducted on a cooperative basis or produces only sufficient income to be self-sustaining, is not a business league.

These provisions have stood in substantially identical form in previous regulations and through repeated reenactments of the statute, and have been uniformly accorded the force of law by this and other Circuit Courts of Appeals. *Retailers Credit Ass'n* v. *Commissioner, supra; Uniform Printing & S. Co.* v. *Commissioner, supra,* p. 447; *Sunset Scavenger Co.* v. *Commissioner,* 84 F. 2d 453, 457 (C. C. A. 9th); *Park West-Riverside Associates, Inc.* v. *Commissioner, supra.*

The regulation thus expresses one of the tests enunciated above and the one ignored by taxpayer's two requirements for exemption. An organization to be exempt must be engaged in the improvement of business conditions of one or more lines of business; it must not perform services for individual persons, and it must not engage in a regular business of a kind normally carried on for profit.

Counsel for taxpayer has devoted a large portion of his brief to arguing that since the taxpayer was organized as a non-profit corporation under the statutes of the State of Washington (Br. 10)—

> It logically follows that unless the petitioner violates the very statute which breathes life into it, it cannot engage in a profit making enterprise, nor distribute any net earnings to its members.

Counsel, in other words, advances the novel proposition that if the taxpayer has abided by the terms of the Washington statute creating it, it is exempt as a business league under the Revenue Act. The position is so patently erroneous that extended discussion is unnecessary. As was pointed out at the beginning of the argument, there are three conjunctive tests of exemption under Section 101 (7). Of these three, one is that the organization must not be organized for profit. A corporation organized not for profit must still establish that it can meet the other two. Counsel's statement that the taxpayer "cannot engage in a profit making enterprise, nor distribute any net earnings to its members" (Br. 10) without violating the Washington statute may very well be correct. These are not, however, the tests of exemption under Section 101 (7). Thus, Article 101 (7)–1 of Treasury Regulations 101 quoted above specifically provides that—

> An organization whose purpose is to engage in a regular business of a kind ordinarily carried on for profit even though the business is conducted on a cooperative basis or produces *only sufficient income to be self-sustaining, is not a business league.* (Italics supplied.)

Moreover, counsel states (Br. 11) that Section 3893 of the Washington Code expressly contemplates the furnishing of supplies to members, and the formation and distribution of a surplus fund. Article 101 (7)–1 of the Regulations, however, specifically provides that an exempt organization may *not* render services to individuals. Furthermore, the distribution of net earnings through the distribution of a surplus fund is "net

earnings'' inuring ''to the benefit of any * * * individual'' as will be developed in part B of the argument. Clearly, therefore, the Washington statute specifically contemplates activities of a corporation directly contrary to the express provisions of Section 101 (7) of the Revenue Act of 1938 and Article 101 (7)–1 of Treasury Regulations 101, promulgated thereunder.

A. The taxpayer is predominantly engaged in businesses of a kind normally carried on for profit and in performing services for individuals so that it is not an exempt business league within Section 101 (7)

No question arises as to the taxpayer being in form a business league. But as this Court said in *Retailers Credit Ass'n* v. *Commissioner, supra* (p. 50), ''All business leagues are not exempt, however. Only those having particular purposes, which do not have the prohibited purposes, *and which operate in the prescribed way are exempt.''* (Italics supplied.) Article 101 (7)–1 of Treasury Regulations 101, as noted *supra,* declares that the prohibited purposes are ''to engage in a regular business of a kind ordinarily carried on for profit'' and ''the performance of particular services for individual persons.'' This interpretation has been consistently applied as the test of an exempt business league. *Retailers Credit Ass'n* v. *Commissioner, supra; Produce Exchange Stock Clearing Ass'n* v. *Helvering, supra; Park West-Riverside Associates, Inc.* v. *Commissioner, supra.*

The *Produce Exchange* case involved a wholly owned subsidiary of the New York Produce Exchange, which was formed in order to aid persons trading in securities

listed on the Produce Exchange to clear their transactions. For the clearing service rendered, a small fixed charge was made. The amount of the charge was originally fixed with a view to just covering expenses, but in the taxable year receipts had exceeded expenditures by a considerable amount. In holding that the taxpayer was not exempt from tax on this income as a "business league", the Court stated (pp. 143):

> The numerous subdivisions of section 103 of the Revenue Act of 1928 (26 USCA § 2103) and the corresponding provisions in the earlier acts, specify organizations which, in the great majority of instances, are evidently granted exemption because of the benefit to be derived by the public from their activities. Cf. *Trinidad* v. *Sagrada Orden,* 263 U. S. 578, 581, 44 S. Ct. 204, 68 L. Ed. 458. There is reason why these should be favored, but none is apparent for exempting an association which merely serves each member as a convenience or economy in his business. This is the distinction which the Board of Tax Appeals and the courts have taken in applying the provision in question to somewhat analogous situations.

Article 101 (7)–1 of Treasury Regulations 101 specifically expresses these tests as follows:

> Thus its activities should be directed to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons.

The regulation also provides that an exempt business league should promote common business interests and

not "engage in a regular business of a kind normally carried on for profit".

Applying these tests to the activities of the taxpayer disclosed by the record, which were also formally announced objectives expressed in its articles of incorporation and by-laws, it is apparent that at least seven distinct types of activities are of a character to exclude the taxpayer from tax exemption. Printing forms and selling them (R. 101) is a business normally carried on by printing establishments. Purchasing such supplies as electric light bulbs and other electrical equipment, and stationery for resale (R. 101–102) is a business regularly carried on for profit by retail stores. Arrangements made by the taxpayer, pursuant to which individual members purchased various supplies directly from a seller at a discount (R. 102), served the convenience and economic interests of individual members of the taxpayer. Supplying information concerning the credit or conduct of tenants (R. 40, 101) is a business of a type normally carried on for profit by credit-reporting organizations. *Retailers Credit Ass'n* v. *Commissioner, supra; Park West-Riverside Associates, Inc.* v. *Commissioner, supra.* Furnishing services of "individuals for apartment shopping" (R. 99) is a business normally carried on for profit. The settlement of controversies between individual members of the taxpayer and labor unions (R. 102) is a convenience to such members. The taxpayer's president testified to this when he said: "Also, if any individual member, or any member of the union, have a misunderstanding, we have a special committee that handles that difficulty,

and it is of very great service to the members." (R. 41.) Publishing and distributing a journal to members (R. 102) served the convenience and economic interest of members. It was testified that the dues were "greatly increased" due to the loss of savings in operations upon discontinuance of the journal after the taxable year. (R. 29.)

All of these activities thus served the convenience and economic interests of individual members, and some constituted a continuing business of a kind normally carried on for profit.

It is true that the taxpayer had other formally stated objectives in its by-laws and articles of incorporation, such as promomting standards and ethical business practices, assisting in the formation of similar associations in other cities of the State of Washington, the promotion of efficiency in the conduct of the members' business, and the elimination of unwise and unfair business practices which may properly be characterized as semi-civic in nature and, therefore, activities of an exempt nature. The applicable principle in determining whether an organization is exempt when there are both exempt and nonexempt activities was stated by this Court in *Retailers Credit Ass'n* v. *Commissioner, supra,* pp. 51, 52, as whether the purpose " 'to engage in a regular business of a kind ordinarily carried on for a profit.' . . . is only incidental or subordinate to the main or principal purposes required by statute . . ." In making this determination "each case must stand on its own facts. No rigid rules may be established as a gauge." In that case it was held

that the supplying of credit information to members and the providing of a collection service was not incidental to the exempt activity of "education of prospective purchasers to base their purchases upon ability to pay therefor."

Webster's New International Dictionary defines the word "incidental" as "Happening as a chance or undesigned feature of something else; casual; hence, not of prime concern; subordinate; collateral; as, an *incidental* conversation; *incidental* expenses. * * *" Certainly it can not be said that the continuing occupation by the taxpayer with printing and selling forms, purchasing supplies for resale to members, arranging for purchases at a discount directly by members, supplying information concerning credit or conduct of tenants, furnishing apartment shopping services and settling controversies of individual members with labor unions, were chance or undesigned features of the association. If anything was incidental it was such objectives as the promotion of standards and ethical business practices and assisting in the formation of similar organizations in other cities of the State of Washington. Whether the nonexempt objectives are "incidental" must also be interpreted in view of the familiar doctrine that a statute creating an exemption must be strictly construed and any doubt must be resolved in favor of the taxing power. *Retailers Credit Ass'n* v. *Commissioner, supra.* This is, however, probably not a situation in which the "incidental" concept need be applied because the taxpayer concerned itself overwhelmingly with nonexempt ac-

tivities. Thus, the Board of Tax Appeals in its findings of fact, while stating that the taxpayer exercised "substantially all" the functions provided for in the articles and by-laws, went on to list the functions which were actually exercised and included the aforelisted nonexempt functions (R. 101–102), but included only one activity which can be classified as exempt. This was in the Board's language, "it [the taxpayer] gave counsel and advice, and did what it could to promote the common welfare of the members." (R. 101.) The only possible interpretation which can, therefore, be put on the Board's finding is that those activities which we argue are of a nonexempt character were the predominant activities of the taxpayer. Moreover, the characterization by the Board, in its opinion (R. 103), of the taxpayer as a "cooperative buying organization" had implicit in it inevitably that one of the nonexempt activities—buying at a discount and selling to members at less than they would otherwise pay—was a major activity. In any event there is nothing in the Board's finding, nor could there be on the record, to indicate how important the exempt activities were. And since a deduction is a matter of legislative grace, the burden is on the taxpayer to bring himself clearly within it. *New Colonial Co.* v. *Helvering,* 292 U. S. 435. Manifestly the taxpayer has failed in this burden.

These findings are supported by substantial evidence and therefore are binding on this Court. *Commissioner* v. *Chicago Graphic Arts F.,* 128 F. 2d 424 (C. C. A. 7th). See also *Palmer* v. *Commissioner,* 302 U. S. 63, 70; *Helvering* v. *Nat. Grocery Co.,* 304 U. S. 282, 294;

Helvering v. *Kehoe,* 309 U. S. 277. In the *Chicago Graphic Arts* case the court felt itself bound by the Board's finding that those activities of the taxpayer which were of a kind ordinarily carried on for profit were incidental to its main or principal purpose.

The Board's conclusion (R. 103) that the taxpayer was a "cooperative buying organization, withholding a margin, however small" is clearly correct. As the Board stated—

> Such cooperatives are not among the exempt organizations of the statute, as are farmers' cooperatives, which buy supplies and turn them over to members at actual cost plus necessary expenses. (Sec. 101 (12).

Analogous reasoning appears in *National Outdoor Advertising Bureau* v. *Helvering,* 89 F. 2d 878, 880 (C. C. A. 2d), where the court said—

> Obviously, Congress did not mean to exempt all marketing or buying cooperative associations; it would not have limited its intent so specifically, and we need not consider whether the exemption, if so construed, is unfairly discriminatory. The Seventh and Ninth Circuits have denied the exemption to corporations no further removed from farmers than the "Bureau," and it seems to us that the point is really not debatable. *Garden Homes* v. *Commissioner,* 64 F. (2d) 593, 596 (C. C. A. 7); *Sunset Scavenger Co.* v. *Commissioner,* 84 F. (2d) 453, 455 (C. C. A. 9).

B. The net earnings of the taxpayer inured to the benefit of its members

Since the requirements for exemption that the taxpayer not engage in a business of a type normally car-

ried on for profit, and no part of its net earnings inure to the benefit of individual members are conjunctive, it is not necessary that the Court find that the net earnings of taxpayer did inure to the benefit of individual members in order to deny exemption. This Court in the *Retailers Credit Association* case, *supra* (p. 52), said—

> All of the conditions regarding the operation are self-explanatory, except as to when net earnings inure to the benefit of private shareholders or individuals * * *.
>
> It is unnecessary to apply these rules in the instant case, because we have already held petitioner is not exempt.

Section 103 (7) denied exemption if any part of the organization's net earnings "inures to the benefit of any private shareholder or individual." Even if, therefore, the taxpayer's activities were not such as to deny exemption, exemption must be denied because net profits inure to the benefit of individual members. *Northwestern Jobbers' Credit Bureau* v. *Commissioner,* 37 F. 2d 880 (C. C. A. 8th); *Uniform Printing & Supply Co.* v. *Commissioner, supra; Fort Worth Grain & Cotton Exchange* v. *Commissioner,* 27 B. T. A. 983. In these cases exemption was denied to organizations of the same private nature as taxpayer on the ground that their net earnings, although not distributed by way of dividends, were available for use in advancing the purposes of the association and therefore inured to the benefit of the individual members of the organization.

Under the rule of these decisions, taxpayer is not

entitled to exemption. Its net earnings, consisting of the excess of dues over expenses, constituted a surplus fund which was available for use in future years to defray part of the cost of rendering the same services to petitioner's members as petitioner rendered during the taxable year. As we have shown, the services directly benefited the business of petitioner's members and consequently funds available to pay for such services inure directly to the benefit of those members.

Moreover, an additional factor is present here that was not in the above cases. Here as the Board specifically found (R. 103) according to Article XVI of the by-laws, the surplus fund may be distributed among the members. Counsel for the taxpayer states on this point (Br. 21)—

> As we understand the theory of the Board of Tax Appeals, any surplus *might be* distributed to members, but the fact still remains, it was not.

Manifestly, if it is sufficient that a surplus fund merely be available to defray part of the costs of rendering the same services to the taxpayer's members as were rendered during the taxable year to be under the above decisions, profit inuring to the benefit of individual members, the additional fact that the surplus fund can, at any time, be distributed to individual members in cash constitutes an *a fortiori* situation.

There remains to be considered the following "issue" listed by taxpayer's counsel (Br. 2):

> 3. Are dues paid by members to defray expenses of a business league, income within the meaning of the Internal Revenue Statute?

This contention was not made before the Board of Tax Appeals and was not referred to in the assignments of error (R. 109) nor in the statement of "Points To Be Relied On Upon Appeal" (R. 111–112) to which the hearing before this Court is confined by its Rule 19 (6). *Bank of America Nat. T. & Sav. Ass'n* v. *Commissioner,* 126 F. 2d 48 (C. C. A. 9th).

Moreover, apart from procedural deficiencies, this contention is without merit. Taxpayer's counsel develops this proposition as follows (Br. 20–21):

> By every rule of mathematics and reason, any surplus must come from the membership dues. Under what theory can these dues be treated as profit? The answer is, obviously, they can not. They were treated and should be treated merely as accumulated funds for the purpose of carrying on the business league.

Counsel has obviously confused the type of operations which are relevant to determining whether taxpayer is an exempt corporation with what constitutes taxable income to a nonexempt organization. Thus the Supreme Court in *Trinidad* v. *Sagrada Orden,* 263 U. S. 578, 581, in holding that the organization was exempt under Section 101 (6) [1] stated:

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[1] In *Waynesboro Manufacturers Association* v. *Commissioner,* 1 B. T. A. 911, the Board said (p. 914):

> We mention this parallel because the Supreme Court has considered subdivision (6), and what it has said about the statutory exemption in the case of corporations which are implicitly not organized for profit applies to the organizations of subdivision (7) which are explicitly so. * * * Cf. also *Produce Exchange Stock Clearing Ass'n, Inc.* v. *Helvering, supra.*

> Whether the contention [that the income from properties devoted exclusively to exempt activities defeats the exemption] is well taken turns primarily on the meaning of the excepting clause, before quoted from the taxing act. Two matters apparent on the face of the clause go far towards settling its meaning. * * * Next, *it says nothing about the source of the income, but makes the destination the ultimate test of exemption.* [Italics added.]

Dues of a nonexempt association are clearly taxable income. *United Retail Grocers Association* v. *Commissioner,* 19 B. T. A. 1016; *Employees' Benefit Assn. of Amer. Steel Foundries* v. *Commissioner,* 14 B. T. A. 1166; *Pontiac Employees Mutual Benefit Assn.* v. *Commissioner,* 15 B. T. A. 74; *Park West-Riverside Associates, Inc.* v. *Commissioner, supra; Commissioner* v. *Chicago Graphic Arts, supra.* In the last two cases the deficiency assessed by the Commissioner was based in large part on revenue consisting of members' dues and the Court did not question in either case what apparently has always been conceded, that such dues are income. In the *Park West-Riverside* case, the organization was held not exempt so that the tax was required to be paid on dues, and in the *Chicago Graphic Arts* case, the business league was held exempt and therefore the income consisting of dues was exempt because the organization was, and not because dues paid to a nonexempt association are not income. In each of the above cases decided by the Board of Tax Appeals, the taxpayer contended that dues were not income and in each case it was held that they were.

Counsel's argument that dues are not "profit" and therefore not taxable is without merit. The statute does not tax "profit" but rather "net income," which is defined in Section 21 as gross income computed under Section 22 less deductions allowed by Section 23. His assertion that the dues are "accumulated funds" and therefore not taxable is equally without merit. That part of the dues became "accumulated funds" merely describes their use. This, of course, has no relevance to a determination of whether it was income when received any more than to say that money coming to a corporation because of the sale of merchandise cannot be income because the recipient put it into surplus. Taxpayer's members paid dues in order to receive the services which the taxpayer could render. Taxpayer has advanced no valid basis on which to exclude dues from income, nor is there any.

The cases which counsel for the taxpayer cites and which deal with the question of whether an organization is exempt under one subsection or another of Section 101 are all distinguishable on their facts. *Crooks* v. *Kansas City Hay Dealers' Assn,* 37 F. 2d 83 (C. C. A. 8th) (Br. 12–13); *Santee Club* v. *White,* 87 F. 2d 5 (C. C. A. 1st) (Br. 14); *Waynesboro Manufacturers Association* v. *Commissioner, supra* (Br. 15); *King County Insurance Association* v. *Commissioner,* 37 B. T. A. 288 (Br. 16–17).

As this Court pointed out in the *Retailers Credit Association* case, *supra, Crooks* v. *Kansas City Hay Dealers' Assn, supra,* is distinguishable because (p. 51)—

> exemption was not denied, where the purpose to engage in a regular business of a kind ordinarily carried on for profit was only incidental to the main and principal purpose.

Indeed, in examining the provisions of the association's constitution in the *Hay Dealers'* case it is difficult to discover any objectives that served the convenience and economic benefit of individual members or constituted a regular business of a kind normally carried on for profit. In the *Santee Club* case counsel relies on the language of the court that (p. 7) "A single transaction of incidental character does not constitute engaging in business." That the language is not applicable to the facts in the case at bar is demonstrated by the fact that the taxpayer is engaged not in one but in numerous kinds of businesses, transacted not once but continuously. The question in *Waynesboro Manufacturers Association* was not, as here, whether the organization's objectives were such as to deny exemption, but was whether the organization was organized not for profit (which is conceded here) and whether any part of the net earnings inured to the benefit of any individual. The only similar issue, therefore, is the question of whether net earnings inured to the benefit of individuals, and on this point the case is not helpful because it did not involve a surplus fund that could be distributed to individual members and the organization was not performing services for individuals on which the expenditure of net earnings could constitute earnings inuring to the benefit of individuals.

The last exempt organization case cited by the taxpayer was *King County Insurance Association, supra.* The Board in that case held (p. 291) that—

> There can be no question but that the petitioner qualifies as a business league exempt from income tax * * * unless it is barred * * * by reason of the fact that it acted as agent in writing insurance policies on so-called "public business."

The Board found that members waived their commissions on insurance policies on properties owned by a municipality in order to provide additional revenue to meet the association's expenses which were incurred entirely because of exempt activities. There is therefore no similarity between that case and the one at bar because there all activities were of the exempt type, whereas here almost all of them are of a nonexempt nature.

Finally, counsel relies on *Inland Empire Etc.* v. *Dept. Pub. Service,* 199 Wash. 527, 92 P. (2d) 258; and *State Ex. Rel. Silver Lake R. & L. Co.* v. *Pub. S. Comm.,* 117 Wash. 453, 201 Pac. 765. (Br. 18–19.) Reliance on these cases is based on counsel's erroneous assumption discussed, *supra,* that a corporation organized under the State of Washington nonprofit corporation act is, as such, exempt under Section 101 (7) of the Revenue Act. The second paragraph quoted by counsel from the opinion in the *Inland Empire* case indicates that the test of compliance with the Washington statute and with Section 101 (7) is in at least one respect diametrically opposed. This quotation is as follows (p. 540):

The service, which is supplied only to members, is at cost, since surplus receipts are returned ratably according to the amount of each member's consumption. There is complete identity of interest between the corporate agency supplying the service and the persons who are being served. It is a league of individuals associated together in corporate form for the sole purpose of producing and procuring for themselves a needed service at cost. In short, so far as the record before us indicates, it is not a public service corporation.

CONCLUSION

The decision of the Board of Tax Appeals should be affirmed.

Respectfully submitted,

SAMUEL O. CLARK, JR.,
Assistant Attorney General.
SEWALL KEY,
IRVING I. AXELRAD,
Special Assistants to the Attorney General.

NOVEMBER, 1942.

U. S. GOVERNMENT PRINTING OFFICE: 1942

No. 10203

IN THE UNITED STATES CIRCUIT COURT OF APPEALS

For the Ninth Circuit

APARTMENT OPERATORS ASSOCIATION,
a corporation,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITIONER'S REPLY BRIEF

EDWARDS MERGES,
JOSIAH THOMAS, AND
CLARENCE L. GERE,
Attorneys for Petitioner.

No. 10203

IN THE
UNITED STATES
CIRCUIT COURT OF APPEALS

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SUBJECT INDEX

TABLE OF CASES

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Respondent.

PETITIONER'S REPLY BRIEF

ARGUMENT

The Courts have ruled construing Treasury Regulations in accordance with contention of Petitioner, that *it is a business league.*

Respondent's answering brief seems to readily admit that the facts are as stated by petitioner in its opening brief, which includes that on the face of the record and under the findings of the Trial Examiner, the only net increase in the income for the year 1938 was $356.35. This is a proceeding in equity and this

Court is empowered to do equity; whether or not every detail of the points relied on checks with the ideas of counsel for respondent. However, these things are mentioned for the purpose of leading to the one and apparently only controverted issue, and that is, what is the test of a business league? Putting it in another way: "is the test *determined* by what respondent *claims* is the *Treasury regulation* (as he sets forth in his brief at the bottom of page 16, and his deductions therefrom), or is it determined by what the *Courts* have *ruled* in regard to Treasury regulations?" Petitioner relies upon what the Courts have heretofore said, and cites the case of *American Society of Cinematographers, Inc., petitioner, vs. Commissioner of Internal Revenue*, 42 B.T.A., 675, as pertinent to the present inquiry.

In that case the petitioner was a non-profit corporation organized under the laws of the State of California. It had no capital stock and no dividends or profits were ever distributed to members. The object of the corporation was, among other things, to bring cinematographers together in order that there might be an 'interchange of ideas and experiences.' The corporation was authorized to own and hold property. Dues were paid by members and a monthly magazine was published. The petitioner represented its members in labor negotiations and had an 'emergency fund' out of which death benefits were paid. The only question presented was whether or not petitioner was exempt

under Sec. 101, Revenue Act of 1934. One of the principal arguments of the respondent there was that the petitioner should not be exempt because it published a magazine. It was held that the petitioner was exempt, and the opinion read, in part, as follows, page 679:

> "The evidence shows that this magazine was at its inception an organ for the dissemination of scientific information to its members. * * * The magazine is concerned exclusively with the publication of articles which are of assistance to its members and to news throughout the world. It was never expected that the magazine would be operated at a profit to the membership. * * *
>
> "The courts have uniformly held that the destination of income rather than the source is the ultimate test of exemption. See Trinidad vs. Sagrada Orden De Predicadores, 263 U. S. 578. In that case the collector claimed that a religious corporation had lost its exempt status because it owned and operated large properties in the Philippines consisting of real estate and stocks in private corporations and loaned money at interest. The Supreme Court held, however, that the corporation was operated exclusively for religious purposes and that it did not lose its exempt status because it realized profits from certain enterprises which were devoted to the objects of the order. *The destination of income was held to be the factor of prime importance.* (Italics ours.)"

It will be noted that in the instant case, the purpose of the Journal or Magazine published by petitioner, was to disseminate information among its members and to allow an exchange of ideas.

As found by the Trial Examiner (Tr. 102) and cited in Petitioner's Opening Brief, p. 5:

> "Petitioner has no purpose or intention of making a profit, but it tries to have a small surplus to assure its continuance."

The case of *Trinidad vs. Sagrada Orden,* supra, gives full answer to the respondent's contention that the articles of merchandise handled by the petitioner places it in the class of a profit making corporation. Since the court is undoubtedly familiar with the facts involved in the *Trinidad* case, supra, it will be unnecessary to restate them here. Suffice it to say that the plaintiff corporation in that case was devoted to religious and charitable work but dealt in certain commodities the profits from which were used in furthering the work of the corporation. In holding the corporation exempt, the court said:

> "As respects the transactions in wine, chocolate and other articles, we think they do not amount to engaging in trade in any proper sense of the term. It is not claimed that there is any selling to the public or in competition with others. The articles are merely bought and supplied for use within the plaintiff's own organization and agencies—some of them for strictly religious use and others for uses which are purely incidental to the work which the plaintiff is carrying on. That the transactions yield some profit is in the circumstances a negligible factor. Financial gain is not the end to which they are directed."

The *Trinidad* case, supra, has been consistently followed by the courts. One of the latest cases in which it was cited is that of *Koon Kreek Klub vs. Thomas,* 108 F. (2) 616. In that case the petitioner was a private fishing and hunting club. This club, however, leased

certain of its lands for money, devoting the proceeds to the purpose of providing hunting and fishing facilities to its members. In holding the club exempt the court said:

> "We think the question is controlled by the decision in Trinidad vs. Sagrada Orden, 263 U. S. 578, * * * wherein the Court points out that the statutes say nothing about the source of the income but makes its destination the ultimate test of exemption. * * * "

The case of *Chicago Graphic Arts Federation, Inc., vs. Commissioner,* Docket No. 97569, entered November 8, 1940, (C.C.H. 11, 380 A) is very similar to the instant case. In that case the petitioner was a non-profit corporation organized under the laws of Illinois. The purpose of the corporation, as set forth in its articles, was, in substance, to promote the welfare of the printing industry by cooperation and dissemination of information among its members. The corporation had an operating personnel consisting of a secretary and others who received salaries, and it maintained offices. There was no capital stock and no dividends were distributed, such being prohibited by the laws under which the corporation was organized, just as in the instant case. The corporation, just as in the instant case, supplied credit information to its members and among other things conducted a waste paper bureau for members wishing to sell waste paper, and conducted an operating course for members. Income was derived through (1) dues, (2) waste paper sales, (3) the operating course. The

only question in the case was whether the corporation was exempt under Sec. 101 of the income tax law as a business league. The Board of Tax Appeals held that the petitioner was exempt and in the course of its opinion said:

> "There is no doubt but that the petitioner may be classed as a 'business league' for it is an association of members having a common business interest. That common business interest is the betterment of the graphic arts industry in and around Chicago. * * *
>
> "We believe that the avowed purposes of the petitioner, as set forth in the original certificate of incorporation and in Article II of the constitution, were to advance and protect business interests, and thus were those of a business league as that phrase is used in the pertinent section of the statute. * * *
>
> " * * * A careful examination of these facts impels us to the conclusion that any business engaged in by the petitioner 'of a kind ordinarily carried on for profit' was only incidental and subordinate to the main or principal purposes required by statute.' "

Respondent avoids the general rule that a written document is to be interpreted, "taking it by its four corners." As found by the Trial Examiner, petitioner *intended* to form a *business league,* and had no *purpose* to *profit,* neither did it *profit.* No isolated phrase or purely incidental act can upset these facts, and no legal construction can logically be based on the theory of the "tail wagging the dog." The ruling contended for by Petitioner makes legal common sense, the other legal nonsense. The one deals fairly, the other unjustly. Con-

gress must have intended to exempt *business leagues* as *such,* or it would not have attempted to do so. It is entirely rational to assume that any incidental advantage of a *business league* would be reflected in greater income revenue from the *business* benefited.

Petitioner's prayer in its opening brief should be granted.

Respectfully submitted,

EDWARDS MERGES,
JOSIAH THOMAS, AND
CLARENCE L. GERE,
Attorneys for Petitioner.

No. 10206

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United States
Circuit Court of Appeals
For the Ninth Circuit.

UNITED STATES OF AMERICA,

Appellant,

vs.

DON LEE, INC.,

Appellee.

Transcript of Record

Upon Appeal from the District Court of the United States
for the Northern District of California,
Southern Division

ROTARY COLORPRINT, 590 FOLSOM ST., SAN FRANCISCO 60-10-7-42

No. 10206

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For the Ninth Circuit.

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Appellant,

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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In the District Court of the United States in and for the Northern District of California, Southern Division

No. 21866-R

DON LEE, INC.,

Plaintiff,

vs.

UNITED STATES OF AMERICA,

Defendant.

COMPLAINT FOR RECOVERY OF TAXES AND INTEREST

Plaintiff complains of defendant and for cause of action alleges:

I.

That this is an action to recover income and excess profit taxes and interest erroneously and illegally assessed and collected. That this action is instituted against the United States of America under the revenue laws of the United States.

II.

That at all times herein mentioned plaintiff was, and now is, a corporation organized and existing under and by virtue of the laws of the State of California with an office in the City and County of San Francisco, State of California. Said office is in the Southern Division of the United States District Court for the Northern District of California.

III.

That on January 1st, 1931, plaintiff owned machinery and equipment, furniture and fixtures, which had a remaining book value of One Hundred Eight Thousand Eight Hundred Ninety and 79/100 Dollars ($108,890.79) as at that date (cost Two Hundred Ninety-two Thousand Three Hundred One and 22/100 Dollars ($292,301.22) less depreciation of One Hundred Eighty-three Thousand Four Hundred Ten [1*] and 43/100 Dollars ($183,410.43)). That on or about said date plaintiff erroneously estimated the life of said property to be ten (10) years from date of acquisition and during the years 1931 to 1935, inclusive, plaintiff entered upon its books and reported on its income tax returns for said years, depreciation on said property computed at the erroneous rate of ten percent (10%) of cost based on said estimated ten (10) year life. That in the years 1931, 1932 and 1933, and each of them, plaintiff sustained operating losses; losses for each said year being in excess of said depreciation reported in each such year.

IV.

That on or about June 8, 1938, defendant estimated the life of said property to be fifteen (15) years from date of acquisition and recomputed the depreciation for the years 1934 and 1935 by erroneously spreading the residual book value of said property at January 1, 1934, (being the cost of said property less depreciation reported by plaintiff in

*Page numbering appearing at foot of page of original certified Transcript of Record.

its income tax returns from date of acquisition to January 1, 1934, based upon an estimated ten (10) year life) over the remaining life of said property, and accordingly disallowed the sum of Five Thousand Eight Hundred Seventy-one and 11/100 Dollars ($5,871.11) as excessive depreciation deducted by plaintiff in its return for the year 1935 and assessed plaintiff an additional tax thereon, which plaintiff paid on July 11, 1938.

V.

That defendant disallowed said portion of said item of depreciation for said year 1935 on the ground that while the rate of depreciation was adjusted in 1934, the base or residual book value of said property at January 1, 1934, (residual book value determined upon the erroneous ten (10) year life rate) should remain unaffected for the reason that palintiff had made excessive [2] claims of depreciation on said property for the years 1931, 1932 and 1933 by reason of using an erroneous ten (10) year life rate of depreciation instead of a fifteen (15) year life rate, and that plaintiff is bound by its error despite the fact that no income was offset by said depreciation reported during said years 1931 to 1933, inclusive.

VI.

That said depreciation for the years 1934 and 1935 should have been recomputed upon said fifteen (15) year life rate by spreading the residual book value of said property at January 1, 1931, together with the cost of additional furniture, fix-

tures and equipment acquired thereafter, over the remaining life of the property, thereby reducing the excessive depreciation reported by plaintiff in the years 1931, 1932 and 1933, in which no taxable income was offset by depreciation and increasing the residual book value of said property at January 1, 1934, January 1, 1935, and January 1, 1936. That had the depreciation for said years been so computed, the excessive depreciation for the year 1935 would have been One Thousand One Hundred Seventy-seven and 07/100 Dollars ($1,177.07) instead of Five Thousand Eight Hundred Seventy-one and 11/100 Dollars ($5,871.11), the amount disallowed. That by reason thereof, plaintiff paid on July 11, 1938, an additional assessed tax for the year 1935 in the excessive amount of Eight Hundred Eighty and 13/100 Dollars ($880.13).

VII.

That the allowable depreciation for the year 1936 based upon the adjusted fifteen (15) year life rate and spreading the residual book value of said property at January 1, 1931, together with the cost of additional property acquired subsequent thereto, over the remaining life of the property, would be Eleven Thousand Three Hundred Twenty-seven and 37/100 Dollars ($11,327.37). That [3] the depreciation allowed by defendant for the year 1936, based upon defendant's erroneous computation as hereinbefore alleged, was the sum of Seven Thousand Five Hundred Ninety-six and 82/100 Dollars ($7,596.82). That by reason of said erroneous

computation of depreciation for the year 1936, plaintiff overpaid its taxes for said year in the sum of One Thousand Two Hundred Nine and 63/100 Dollars ($1,209.63). That a portion of plaintiff's taxes for the year 1936 is represented by an additional assessment on June 8, 1938, in the sum of Seven Hundred Fifty-seven and 64/100 Dollars ($757.64) which plaintiff paid on July 11, 1938.

VIII.

That on or about June 26, 1940, plaintiff duly filed with the Collector of Internal Revenue of the First District of California, two separate claims for refund of excessive income and excess profit taxes assessed and paid for the years 1935 and 1936 based upon the erroneous computation of depreciation for said years, as hereinabove set forth.

IX.

That thereafter, and on or about January 25, 1941, said claims for refund were rejected by the Commissioner of Internal Revenue, and no part of said taxes have been refunded to or received by plaintiff.

X.

That plaintiff is not subject to the tax erroneously and illegally assessed and collected as hereinabove set forth for the reason that excessive depreciation reported on said property for the years 1931, 1932 and 1933, but not deducted from taxable income since plaintiff sustained operating losses in each such year, was not "allowed" within the meaning of the United States Revenue Act or Acts. That

said reported depreciation for said years 1931 to 1933, inclusive, should be adjusted on the basis of an original [4] life of fifteen (15) years, resulting in a reduction of the depreciation in each said year, and a higher remaining base, or a greater net book value of said property on January 1, 1935, and January 1, 1936, and a greater amount of depreciation for each of said latter years.

Wherefore, plaintiff prays for judgment against defendant in the total sum of Two Thousand Eighty-nine and 76/100 Dollars ($2,089.76), together with interest thereon at the statutory rate from the dates when said sum was paid, and for such other relief as may be proper in the premises.

ZAGON and AARON,
By MARVIN MANUEL,
Attorneys for Plaintiff.

[Endorsed]: Filed May 7, 1941 [5]

[Title of District Court and Cause.]

ANSWER

Comes now Frank J. Hennessy, United States Attorney for the Northern District of California, and for answer to the complaint filed in this action, admits and denies as follows:

I.

Answering the allegations of Paragraph I, admits that the action was filed for recovery of income and

excess profits taxes and interest paid by plaintiff, and that the action is brought under the revenue laws of the United States. Denies that said taxes were illegally or erroneously assessesed or collected.

II.

Admits the allegations of Paragraph II. [6]

III.

Answering Paragraph III, admits that on January 1, 1931, plaintiff owned machinery equipment, furniture and fixtures which were depreciable property and were subject to depreciation allowance. Admits that in its income tax returns for the years 1931, 1932 and 1933 plaintiff took $108,890.79 as the book value of said assets as of January 1, 1931 (computed as alleged) and that in its books of account, and in its returns for 1931, 1932 and 1933, plaintiff computed depreciation on the basis of a 10-year life from the date of acquistion, and claimed deductions on said basis. Admits that in its returns for 1931, 1932 and 1933 plaintiff claimed and reported operating losses which were in excess of the amount of depreciation reported for each of said years. Saving as herein admitted, defendant denies the allegations of *of* Paragraph III.

IV.

Answering Paragraph IV of the complaint, defendant admits that in June, 1938, defendant, by its officers of the Internal Revenue Bureau, estimated 15 years as the life of said properties from the date

of acquisition and recomputed the annual allowable depreciation. Admits that said recomputation was made for the years 1934 and 1935 and were based upon the plaintiff's book value thereof as of January 1, 1934. Admits that the deduction of $5,871.11, claimed in plaintiff's return for 1935, was disallowed. Admits that by reason thereof, an additional tax was assessed against plaintiff for 1935. Excepting as herein admitted, defendant denies the allegations of Paragraph IV.

V.

Denies the allegations of Paragraph V. [7]

VI.

Answering Paragraph VI, admits that on July 11, 1938, plaintiff paid an additional tax of $880.13 based upon an adjustment of the depreciation allowable on the properties referred to in the complaint. Admits that $5,871.11 was the amount disallowed. Denies the remaining allegations of Paragraph VI.

VII.

Answering the allegations of Paragraph VII, admits that the depreciation disallowed on said properties for the year 1936 was $7,596.82. Admits that on June 8, 1939, plaintiff paid an additional assessment amounting to $757.64. Denies the remaining allegations of Paragraph VII.

VIII.

Answering Paragraph VIII, admits that plaintiff filed claims for refund for 1935 and 1936 on the

grounds alleged in Paragraph VIII of the complaint. Denies that said taxes were excessive, and denies that the computation of depreciation was erroneous.

IX.

Admits the allegations of Paragraph IX of the complaint.

X.

Denies the allegations of Paragraph X of the complaint.

Wherefore defendant prays for judgment in its favor, for its costs and for such other relief as may be just.

FRANK J. HENNESSY,
United States Attorney.
ESTHER B. PHILLIPS,
Assistant United States Attorney.

[Endorsed]: Filed Jul. 18, 1941. [8]

[Title of District Court and Cause.]

STIPULATION OF FACTS

It is hereby Stipulated and Agreed by and between the parties hereto, through their respective counsel, that the following facts shall be taken as true, provided, however, that this stipulation shall be without prejudice to the rights of either party to introduce other and further evidence not inconsistent

with the facts herein stipulated to be taken as true and to object at the trial of this case to any of the facts stipulated as being irrelevant or immaterial.

(1) The plaintiff, Don Lee, Inc., at all times hereinafter mentioned, was a corporation organized under and existing by virtue of the laws of the State of California, with an office in the City and County of San Francisco. [9]

(2) The United States of America, the defendant, at all times hereinbefore mentioned, was a corporation sovereign and body politic.

(3) This is a suit of a civil nature arising under the laws of the United States to recover an alleged overpayment of taxes, with interest.

(4) That the plaintiff, on or about January 1, 1931, was the owner of depreciable machinery, equipment, furniture and fixtures, subject to depreciation allowance, which cost $292,301.22 and which, after deducting depreciation of $183,410.43, had a book value as of January 1, 1931, of $108,-890.79. The plaintiff on its books of account computed depreciation on the basis of a ten-year life from the date of acquisition of said properties. In filing its income tax returns for the years 1931, 1932, 1933, 1934, 1935 and 1936, the plaintiff reported a deduction of depreciation on the same basis.

(5) On March 14, 1936, the plaintiff filed its income tax return for the calendar year 1935 showing its gross income and deductions, among which was an item of depreciation in the amount of $40,271.08, and a net income on which income and

excess profit taxes of $32,454.83 were payable, and which were paid in quarterly installments in 1936.

(6) Thereafter, the Commissioner of Internal Revenue determined that the depreciation allowable to the plaintiff for the year 1935 was not $40,271.08, as reported, but was $34,399.97. This, and other adjustments not in dispute, increased the net income and made an additional tax due. A notice of deficiency in income and excess profits tax of $3,808.50, interest $517.91, a total of $4,326.41 was duly given, which was paid on July 12, 1938.

(7) On March 15, 1937, the plaintiff filed its income tax return for the calendar year 1936 showing gross income and deductions, among which was an item of depreciation in the amount [10] of $37,816.58, and a net income on which an income tax of $59,695.16 was due, which was paid in quarterly installments in 1937.

(8) Thereafter, upon facts coming to his attention, the Commissioner of Internal Revenue made adjustments (not now in dispute) which increased the net income and resulted in a defiiciency in income tax of $757.64. This deficiency was paid on July 12, 1938 by the plaintiff, together with interest amounting to $57.57, or a total amount of $815.21. Thereafter, the plaintiff filed its claim for refund for 1936, in which plaintiff claimed that additional depreciation for 1936 ought to be allowed amounting to $3,730.55.

(9) The dispute as to allowable depreciation resulted from a determination by the Commissioner of Internal Revenue made in June, 1938 that cer-

tain property upon which depreciation was taken by the plaintiff had a normal and useful life of 15 years from date of acquisition thereafter, and that the depreciation allowable thereafter should be computed on that basis and not on the basis of a life of 10 years as had previously been done by the plaintiff.

(10) The plaintiff filed its claim for refund of tax and interest for the years 1935 and 1936 on June 27, 1940. Said claims for refund were based on the ground that the life of the assets in question was 15 years from date of acquisition, and that since plaintiff sustained operating losses for the years 1931, 1932 and 1933, depreciation for those years should be adjusted on the basis of a normal useful life of said depreciating property amounting to 15 years from date of acquisition, and that if depreciation for those years were so adjusted, the book value of the assets as of January 1, 1934 would be increased and a larger amount of depreciation for 1935 and 1936 would be allowable. These claims for refund were rejected by the Commissioner of Internal Revenue on May 10, 1941. No part of the tax and interest [11] in dispute herein has been refunded to the plaintiff. The plaintiff sustained operating losses during the years 1931, 1932 and 1933 which, in fact, exceeded the depreciation reported.

(11) It is Stipulated that allowance for depreciation for the years 1935 and 1936 upon the basis of a 15-year useful life from the date of acquisition is correct.

(12) It is Stipulated that the plaintiff computed depreciation allowance for 1931, 1932 and 1933 on the basis of a 10-year useful life from the date of acquisition.

(13) It is Stipulated that if plaintiff's contention referred to in Paragraph (10) above is correct, and that the book value of said properties as of January 1, 1934 should be increased by the amount of excessive depreciation reported for the income tax returns for 1931, 1932 and 1933, then the allowable depreciation for 1935 should be increased by $4,694.04, and the plaintiff has overpaid its income tax for 1935 in the amount of $880.13; and the allowable depreciation for 1936 should be increased by $3,730.55. Plaintiff's overpayment of income tax for 1936, if the allowable depreciation is so increased, would amount to $1,209.63, of which $757.64, with interest, was paid on July 11, 1938. The statute of limitations has run on recovery of sums paid prior to July 11, 1938, in so far as the 1936 tax is concerned.

ZAGON and AARON,
By HAROLD E. AARON,
Attorney for Plaintiff.
FRANK J. HENNESSY,
United States Attorney,
ESTHER B. PHILLIPS,
Assistant United States
Attorney.

[Endorsed]: Filed Nov. 18, 1941. [12]

[Title of District Court and Cause.]

STIPULATION FOR SUBMISSION OF CAUSE

It Is Hereby Stipulated by and between the parties hereto through their respective counsel, that the within cause now set for trial on November 24, 1941, may be submitted for decision upon the written stipulation of facts herein, all of the files and records of said cause, the within stipulation and briefs of the parties to be filed as follows:

(a) Plaintiff's brief to be filed within ten days following submission of said cause;

(b) Defendant's brief to be filed within twenty days thereafter; and

(c) Plaintiff's reply brief to be filed within ten [13] days after the filing of defendant's brief.

Dated: November 17, 1941.

ZAGON and AARON,
By HAROLD E. AARON,
Attorneys for Plaintiff.
FRANK J. HENNESSY,
United States Attorney.
ESTHER B. PHILLIPS,
Assistant United States Attorney,
Attorneys for Defendant.

[Endorsed]: Filed Nov. 18, 1941. [14]

[Title of District Court and Cause.]

MEMORANDUM OPINION

Roche, District Judge:

This is an action brought by plaintiff, Don Lee, Inc., to recover overpayment of Income and Excess Profits Taxes for the years 1935 and 1936, together with interest thereon.

In making its tax returns for the years 1931, 1932 and 1933, plaintiff computed depreciation upon its machinery, fixtures, and other depreciable property on the basis of a ten year life. Thus it made annual deductions of 10% of the value of the property for the three years. Thereafter the Commissioner of Internal Revenue estimated that fifteen years was the useful life of the property, and he recomputed the allowable depreciation for the years 1934 and 1935. The Commissioner used the following method. He took plaintiff's book value as of January 1, 1934, when it showed the original cost of the property, less depreciation for three years [15] on the basis of a ten year life. He spread this sum over the remaining twelve years of the fifteen year period which he fixed as the life of the property for future tax depreciation purposes. In 1936 plaintiff made its return on the twelve year evaluation basis used by the Commissioner of Internal Revenue in computing depreciation.

In each of the years 1931, 1932 and 1933, when plaintiff was reporting a 10% deduction for depreciation, its operating expenses and other deduc-

tions exceeded its gross income. Thus plaintiff was making no profits from which it might deduct its annual cost of depreciation.

On June 27, 1940, plaintiff filed with the Collector of Internal Revenue of the First District of California its claim for taxes erroneously assessed and overpaid for the years 1935 and 1936, together with interest. Plaintiff based its claims on the ground that the life of plaintiff's assets was fifteen years from the date of acquisition, as fixed by the Commissioner. Plaintiff asserted that since it had sustained losses for the years 1931, 1932 and 1933, its depreciation for those years should be adjusted in accordance with a fifteen year life, from the date of acquisition. Instead of deducting 10% for the three years in question, plaintiff should be permitted to reduce the excessive deductions so as to meet the requirements for equal deductions over the entire fifteen year period. Thus, the book value of plaintiff's property on January 1, 1934 would be increased, and a larger amount of depreciation would be allowable for 1935 and 1936. The Commissioner refused to make the requested refunds on May 10, 1941.

Plaintiff contends that the book value of the depreciable property should be increased by the amount of the excessive depreciation reported so that the allowable depreciation for the challenged years will be increased accordingly. If plaintiff's contention is correct, it is entitled to recover an overpayment of taxes. [16]

The question for decision is as follows: Where plaintiff reports excessive depreciation of property for three years, but does not benefit from such depreciation by an offset of income for these years because of business losses, should the portion of depreciation beyond the amount legally allowable be added to the value of the property for future depreciation?

The answer to this question rests on the interpretation of certain sections of the Revenue Acts of 1934 and 1936, which are applicable to the case presented to the court.

It must first be noted that a reasonable allowance is permitted to be deducted as depreciation in computing net income of a trade or business (Sec. 23 (1) of the Revenue Acts of 1934 and 1936). The basis for this depreciation is the same adjusted basis as that which is used for determining gain upon the sale of such property (Sec. 114 (a) of the Revenue Acts of 1934 and 1936). The adjusted basis shall be the cost (Sec. 113 (a), less deductions for depreciation to the extent allowed (but not less than the amount allowable), (Sec. 113 (b) and 113 (b) (1) (B) of the Revenue Acts of 1934 and 1936, and Art. 113 (b)-1 of Regs. 86 and 94).

The parties before the Court dispute the basis for depreciation. The above sections of the Revenue Act hold that the basis must be determined by decreasing the cost of the property by the amount of depreciation "allowed", but not less than the amount allowable. The life of plaintiff's property

is agreed to be fifteen years. Plaintiff contends that depreciation computed on a fifteen year life is the amount "allowable", and that depreciation based on a ten year life is in excess of the amount allowable. If plaintiff's contention is sound, then it made excessive deductions in the years 1931, 1932, and 1933. If these were not "allowed" within the meaning of the Revenue Act, the basis for future depreciation must be adjusted. What is meant by the term "allowed"? [17]

In the case of Pittsburg Brewing Company vs. Commissioner (1939), 107 F2nd 155, the court carefully construed the word "allowed" as it is used in Clause B of Section 113 (b) (1) of the Revenue Acts of 1934 and 1936, and Art. 113 (b)-1 of Regs. 86 and 94. In the Brewing Company suit, the taxpayer made depreciation deductions which were in excess of the correct amount, when based upon an adjusted value of the property as finally fixed by the government. The taxpayer asked the Commissioner to reduce the depreciation deductions to accord with the reduced value of the property. By lowering the deductions, the Commissioner would be increasing the value of the property, which the taxpayer had sold, and would thus be cutting the amount of taxable gain realized by the taxpayer on the sale of his property. The Commissioner refused to allow the depreciation deductions to be modified, on the ground that they had already been "allowed". The court took a contrary position, declaring in part:

> "* * * is depreciation 'allowed' only if it is actually deducted from taxable income or must it also be considered as 'allowed' if it is reported on an income tax return but not taken as a deduction because of insufficiency of income? After full consideration of this question we have reached the conclusion that depreciation is not 'allowed' within the meaning of the act unless it is actually taken as a deduction against taxable income.
>
> " 'Allow' is defined as 'To grant (something) as a deduction or an addition; esp., to abate or deduct; as, to allow a sum for leakage.' Webster's New International Dictionary, 2d Ed., p. 70, def. 5. 'Allowed' in the statute accordingly means granted as a deduction. Deduction is defined as 'That which is deducted; the part taken away; as a deduction from the yearly rent.' Webster's New International Dictionary, 2d Ed., p. 284, Def. 2b. * * *"

The court then held that depreciation was not allowed solely by reason of the fact that it had been reported as a deduction. It was also necessary that the deduction should have reduced taxable income. Since the prior deductions which exceeded the depreciation "allowable", did not reduce taxable income, the depreciation might properly be adjusted to eliminate the amount in excess of that allowable.

The only distinction between the above case and the [18] matter before the Court is that in the Brewing Company suit the taxpayer miscalculated

the original value of the property while in the case at bar the plaintiff erred in estimating the life of the property. This distinction does not alter the meaning of the term "allowable", which is the same in both cases.

Plaintiff's excess depreciation did not reduce its income tax payments in the years 1931, 1932, and 1933. Therefore, the deductions for these years were not "allowed", within the meaning of the Revenue Acts of 1934 and 1936, and plaintiff is entitled to have its excess depreciation added to the basis for depreciation in subsequent years.

Accordingly the Court will enter judgment in favor of plaintiff as prayed for, upon preparation of findings of fact and conclusions of law. Defendant will pay costs.

Dated: February 3, 1942.

(Signed) MICHAEL J. ROCHE,
United States District Judge.

[Endorsed]: Filed Feb. 3, 1942. [19]

[Title of District Court and Cause.]

FINDINGS OF FACT AND CONCLUSIONS OF LAW

This matter having come on regularly for trial on the 24th day of November, 1941, and the cause having been submitted on Stipulation of Facts and the admissions in the pleadings, and briefs having been

filed thereafter, and the Court having duly considered the facts, the issues of law and the argument of counsel, now makes the following

FINDINGS OF FACT

I.

The Court adopts the Stipulation of Facts made by the parties and by reference incorporates the same herein. [20]

CONCLUSIONS OF LAW

(1) That plaintiff paid excessive income and excess profits taxes for the year 1935 in the sum of $880.13, which it paid to the United States Collector of Internal Revenue on July 11, 1938. Plaintiff paid excessive income and excess profits taxes for the year 1936 in the sum of $1209.63, of which amount $757.64 was paid on July 11, 1938. The balance of the overpayment of taxes for the year 1936 was paid prior to July 11, 1938, and said balance is barred by the statute of limitations.

(2) That plaintiff is entitled to judgment in the sum of $880.13 and $757.64, with interest thereon as provided by law from July 11, 1938, and for its costs as may be taxed.

Dated: March 30th, 1942.

MICHAEL J. ROCHE,
United States District Judge.

[Endorsed]: Filed Mar. 30, 1942. [21]

In the District Court of the United States for the Northern District of California, Southern Division

No. 21866-R

DON LEE, INC.,

Plaintiff,

vs.

UNITED STATES OF AMERICA,

Defendant.

JUDGMENT

This matter having come on for trial and having been submitted on the stipulation of facts, briefs, having been filed and the Court having made its Findings of Fact and Conclusions of Law,

No, Therefore, It Is Hereby Ordered, Adjudged and Decreed that plaintiff have judgment against defendant in the sum of Sixteen Hundred Thirty-seven and 77/100 Dollars ($1,637.77), together with interest thereon at the rate of six per cent (6%) per annum from July 11, 1938, and for its costs taxed in the sum of $24.60.

Dated: This 30th day of March, 1942.

MICHAEL J. ROCHE,
Judge.

[Endorsed]: Filed Mar. 30, 1942. [22]

[Title of District Court and Cause.]

NOTICE OF APPEAL

Now comes the defendant, the United States of America, appearing by Frank J. Hennessy, United States Attorney for the Northern District of California, and hereby appeals from the judgment heretofore entered in the above entitled case in favor of the plaintiff.

Dated: May 27, 1942.

FRANK J. HENNESSY,
United States Attorney.
ESTHER B. PHILLIPS,
Assistant United States Attorney.

[Endorsed]: Filed May 27, 1942, [23]

[Title of District Court and Cause.]

ORDER EXTENDING TIME TO DOCKET RECORD ON APPEAL

Upon motion of the United States Attorney for the Northern District of California, it is hereby Ordered that the defendant the United States of America, may have to and including July 27, 1942, in which to docket its record on appeal in the above-entitled case.

Dated: July 14th, 1942.

MICHAEL J. ROCHE,
United States District Judge.

[Endorsed]: Filed July 14, 1942. [24]

[Title of District Court and Cause.]

DESIGNATION OF RECORD ON APPEAL

The defendant above-named having taken an appeal from the judgment entered herein on March 30, 1942 to the United States Circuit Court of Appeals for the Ninth Circuit, hereby designates the following parts of the record and proceedings for inclusion in the record on appeal:

(1) The complaint;

(2) The answer;

(3) Stipulation of facts filed November 17, 1941;

(4) Stipulation for submission of cause filed November 17, 1941;

(5) Opinion of the Court filed February 6, 1942;

(6) Findings of Fact and Conclusions of Law filed March 30, 1942. [25]

(7) Judgment entered March 30, 1942;

(8) Notice of Appeal filed May 27, 1942;

(9) This designation of the record on appeal;

(10) Statement of the points intended to be relied upon by defendant in its appeal.

FRANK J. HENNESSY,
United States Attorney.

[Endorsed]: Filed Jul. 18, 1942. [26]

[Title of District Court and Cause.]

STATEMENT OF POINTS TO BE RELIED UPON BY DEFENDANT ON THE APPEAL TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

Comes now the United States of America, defendant and appellant herein, and hereby states the points intended to be relied upon on the appeal of the above-entitled case:

(1) In a case involving the proper method of computing depreciation after it had been determined that the remaining life of a taxpayer's depreciable assets was longer than that originally estimated, the defendant and appellant assigns error to the District Court in that he failed to hold that the cost basis of such assets to be recovered at the [27] new rate of depreciation (6 2-3%) is cost, less depreciation deducted at a higher rate (10%) on the previous returns which had been accepted by the Commissioner.

(2) In such case the defendant assigns error to the District Court in holding that since the taxpayer had received no tax advantages from the deductions at the higher rate (10%) in the previous returns, the cost basis to be recovered should be reduced by depreciation computed for previous years at the new rate of 6 2-3 per cent.

FRANK J. HENNESSY,
United States Attorney.

[Endorsed]: Filed Jul. 18, 1942. [28]

District Court of the United States
Northern District of California

CERTIFICATE OF CLERK TO TRANSCRIPT OF RECORD ON APPEAL

I, Walter B. Maling, Clerk of the District Court of the United States, for the Northern District of California, do hereby certify that the foregoing 28 pages, numbered from 1 to 28, inclusive, contain a full, true, and correct transcript of the records and proceedings in the case of Don Lee, Inc., Plaintiff, vs. United States of America, Defendant, No. 21866-R, as the same now remain on file and of record in my office.

I further certify that the cost of preparing and certifying the foregoing transcript of record on appeal is the sum of Three dollars and eighty cents ($3.80) and that the said amount has been paid to me by the Attorney for the appellant herein.

In Witness Whereof, I have hereunto set my hand and affixed the seal of said District Court at San Francisco, California, this 22nd day of July, A. D. 1942.

[Seal] WALTER B. MALING,
Clerk.
WM. J. CROSBY,
Deputy Clerk. [29]

[Endorsed]: No. 10206. United States Circuit Court of Appeals for the Ninth Circuit. United States of America, Appellant, vs. Don Lee, Inc., Appellee. Transcript of Record. Upon Appeal from the District Court of the United States for the Northern District of California, Southern Division.

Filed July 24, 1942.

PAUL P. O'BRIEN,

Clerk of the United States Circuit Court of Appeals for the Ninth Circuit.

In the United States Circuit Court of Appeals for the Ninth Circuit

No. 10206

UNITED STATES OF AMERICA,

Appellant,

vs.

DON LEE, INC.,

Appellee.

DESIGNATION OF POINTS TO BE RELIED UPON BY APPELLANT ON THE APPEAL TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

The Appellant hereby designates the points to be relied upon in the prosecution of the appeal before

this court, the same points designated in the Discourt Court, namely:

(1) In a case involving the proper method of computing depreciation after it had been determined that the remaining life of a taxpayer's depreciable assets was longer than that originally estimated, the appellant assigns error to the District Court in that he failed to hold that the cost basis of such assets to be recovered at the new rate of depreciation (6 2-3%) is cost, less depreciation deducted at a higher rate (10%) on the previous returns which had been accepted by the Commissioner.

(2) In such case the appellant assigns error to the District Court in holding that since the taxpayer had received no tax advantages from the deductions at the higher rate (10%) in the previous returns, the cost basis to be recovered should be reduced by depreciation computed for previous years at the new rate of 6 2-3 per cent.

FRANK J. HENNESSY,
United States Attorney.

[Endorsed]: Filed July 24, 1942.

[Title of Circuit Court of Appeals and Cause.]

DESIGNATION OF RECORD TO BE PRINTED ON APPEAL

To the Clerk of the United States Circuit Court of Appeals for the Ninth Circuit:

The appellant herein designates the entire record lodged herein as the record to be printed on appeal.

FRANK J. HENNESSY,
United States Attorney.

[Endorsed]: Filed July 24, 1942.

No. 10,206

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

UNITED STATES OF AMERICA,
Appellant,

vs.

DON LEE, INC.,
Appellee.

On Appeal from the District Court of the United States for the Northern District of California, Southern Division.

BRIEF FOR THE UNITED STATES.

SAMUEL O. CLARK, JR.,
Assistant Attorney General,
SEWALL KEY,
L. W. POST,
Special Assistants to the Attorney General,
FRANK J. HENNESSY,
United States Attorney,
ESTHER B. PHILLIPS,
Assistant United States Attorney,
Attorneys for Appellant.

PERSAE-WALSH PRINTING CO., SAN FRANCISCO

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No. 10,206

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

UNITED STATES OF AMERICA,
Appellant,

vs.

DON LEE, INC.,
Appellee.

On Appeal from the District Court of the United States for the Northern District of California, Southern Division.

BRIEF FOR THE UNITED STATES.

OPINION BELOW.

The memorandum opinion of the District Court (R. 16-21) is reported in 42 F. Supp. 884.

JURISDICTION.

This is an action for the recovery of income and excess profits taxes paid. The complaint, filed May 7, 1941 (R. 2-7), alleges that the taxes were illegally exacted and that the claims for refund, filed June 26, 1940, were rejected on January 25, 1941 (R. 6); also, that the action is instituted under the revenue laws of

the United States (R. 2). While the complaint does not refer specifically to the statutory provision believed to sustain jurisdiction, it is assumed that the jurisdiction of the District Court was invoked under Section 24 (20) of the Judicial Code, as amended. The case is brought to this Court by notice of appeal filed May 27, 1942 (R. 24), from the judgment of the District Court entered March 30, 1942 (R. 23). The jurisdiction of this Court rests upon Section 128 (a) of the Judicial Code, as amended.

QUESTION PRESENTED.

Whether, in computing depreciation for the years 1935 and 1936 under Sections 23, 113 and 114 of the Revenue Acts of 1934 and 1936, the taxpayer's basis should be reduced by the amount deducted for depreciation in prior years (1931 to 1933, inclusive) in excess of that properly allowable where the excess was not offset by taxable income for those years.

STATUTES AND REGULATIONS INVOLVED.

Revenue Act of 1934, c. 277, 48 Stat. 680:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> * * * * * * *
>
> (l) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear of property used in

the trade or business, including a reasonable allowance for obsolescence. * * *

* * * * * * *

(n) *Basis for Depreciation and Depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

* * * * * * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) *General Rule.*—Proper adjustment in respect of the property shall in all cases be made—

* * * * * * *

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws. * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) *Basis for Depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b)

for the purpose of determining the gain upon the sale or other disposition of such property.

Sections 23 (l) and (n), 113 (b) (1) (B) and 114 (a) of the Revenue Act of 1936 contain the same provisions as those of the Revenue Act of 1934, above quoted.

The applicable regulations are Articles 23 (l)-1, 2, 4, 5 and 9, 113 (b)-1 and 114-1 of Treasury Regulations 86 and 94, relating to the Revenue Acts of 1934 and 1936.

STATEMENT.

Pursuant to stipulation (R. 15), the case was submitted to the District Court for decision upon the stipulation of facts and the pleadings (R. 21). Thereafter briefs were filed and the court made special findings of fact and conclusions of law (R. 22) and gave judgment for the taxpayer in the principal sum of $1,637.77 (R. 23) from which judgment this appeal has been taken.

The following facts were stipulated (R. 10-14) and found by the District Court (R. 22):

The taxpayer, Don Lee, Inc., at all times hereinafter mentioned, was a corporation organized under the laws of California, with an office in San Francisco. (R. 11.)

The taxpayer, on or about January 1, 1931, was the owner of depreciable machinery, equipment, furniture and fixtures, subject to depreciation allowance, which

cost $292,301.22 and which, after deducting depreciation of $183,410.43, had a book value as of January 1, 1931, of $108,890.79. The taxpayer on its books of account computed depreciation on the basis of a ten-year life from the date of acquisition of the properties. In filing its income tax returns for the years 1931, 1932, 1933, 1934, 1935 and 1936, the taxpayer reported a deduction of depreciation on the same basis. (R. 11.)

On March 14, 1936, the taxpayer filed its income tax return for the calendar year 1935 showing its gross income and deductions, among which was an item of depreciation in the amount of $40,271.08, and a net income on which income and excess profit taxes of $32,454.83 were payable, and which were paid in quarterly installments in 1936. (R. 11-12.)

Thereafter, the Commissioner of Internal Revenue determined that the depreciation allowable to the taxpayer for the year 1935 was not $40,271.08, as reported, but was $34,399.97. This, and other adjustments not in dispute, increased the net income and made an additional tax due. A notice of deficiency in income and excess profits tax of $3,808.50, interest $517.91, a total of $4,326.41, was duly given, which was paid on July 12, 1938. (R. 12.)

On March 15, 1937, the taxpayer filed its income tax return for the calendar year 1936 showing gross income and deductions, among which was an item of depreciation in the amount of $37,816.58, and a net income on which an income tax of $59,695.16 was due, which was paid in quarterly installments in 1937. (R. 12.)

Thereafter, upon facts coming to his attention, the Commissioner made adjustments (not now in dispute) which increased the net income and resulted in a deficiency in income tax of $757.64. This deficiency was paid on July 12, 1938, by the taxpayer, together with interest amounting to $57.57, or a total amount of $815.21. Thereafter, the taxpayer filed its claim for refund for 1936, in which taxpayer claimed that additional depreciation for 1936 ought to be allowed amounting to $3,730.55. (R. 12.)

The dispute as to allowable depreciation resulted from a determination by the Commissioner made in June, 1938, that certain property upon which depreciation was taken by the taxpayer had a normal and useful life of 15 years from date of acquisition, and that the depreciation allowable thereafter should be computed on that basis and not on the basis of a life of 10 years. (R. 12-13.)

The taxpayer filed its claim for refund of tax and interest for the years 1935 and 1936 on June 27, 1940. These claims were based on the ground that the life of the assets in question was 15 years from date of acquisition, and that since taxpayer sustained operating losses for the years 1931, 1932 and 1933, depreciation for those years should be adjusted on the basis of a normal useful life of 15 years from date of acquisition, and that if depreciation for those years were so adjusted, the book value of the assets as of January 1, 1934, would be increased and a larger amount of depreciation for 1935 and 1936 would be allowable. The claims for refund were rejected on May 10, 1941. No

part of the tax and interest in dispute herein has been refunded to the taxpayer. The taxpayer sustained operating losses during the years 1931, 1932 and 1933 which, in fact, exceeded the depreciation reported. (R. 13.)

Allowance for depreciation for the years 1935 and 1936 upon the basis of a 15-year useful life from the date of acquisition is correct. (R. 13.)

The parties stipulated that if taxpayer's contention is correct, and the book value of the properties as of January 1, 1934, should be increased by the amount of excessive depreciation reported for the income tax returns for 1931, 1932 and 1933, then the allowable depreciation for 1935 should be increased by $4,694.04, and the taxpayer has overpaid its income tax for 1935 in the amount of $880.13; and the allowable depreciation for 1936 should be increased by $3,730.55. Taxpayer's overpayment of income tax for 1936, if the allowable depreciation is so increased, would amount to $1,209.63, of which $757.64, with interest, was paid on July 11, 1938. The statute of limitations has run on recovery of sums paid prior to July 11, 1938, in so far as the 1936 tax is concerned. (R. 14.)

As stated above, the District Court gave judgment for the taxpayer and the United States took this appeal.

STATEMENT OF POINTS TO BE URGED.

The District Court erred:

1. In not holding that the taxpayer's basis to be recovered at the new depreciation rates is cost less depreciation deducted on previous returns which were accepted by the Commissioner, even though depreciation in those returns was excessive and the excess was not offset by taxable income.

2. In entering judgment for the taxpayer.

SUMMARY OF ARGUMENT.

The decision of the District Court is plainly unsound. Sections 114 (a) and 113 (b) (1) (B) of the Revenue Acts of 1934 and 1936 provide that in determining the basis for depreciation, proper adjustment shall be made in respect of earlier years, for depreciation, to the extent allowed (but not less than the amount allowable) under the Act or prior income tax laws. The decision below would confine the adjustments to the amount allowable even though the taxpayer actually claimed more as deductions in prior years and the Commissioner did not oppose. That result is contrary to the statute. It is immaterial whether the amounts in question were offset by taxable income, for the statute does not depend for its operation upon considerations of whether the taxpayer derived any tax advantage from the deductions in prior years.

ARGUMENT.

THE TAXPAYER'S BASIS SHOULD BE REDUCED BY THE ENTIRE AMOUNT OF DEPRECIATION CLAIMED AND ALLOWED FOR PRIOR YEARS.

Section 114 (a) of the Revenue Acts of 1934 and 1936, *supra,* provides that the basis for depreciation shall be the adjusted basis provided in Section 113 (b), *supra,* for the purpose of determining the gain upon sale or other disposition of the property. Section 113 (b) (1) (B) provides that in determining such basis, proper adjustment shall be made in respect of any period since February 28, 1913, for depreciation, to the extent allowed (but not less than the amount allowable) under the Act or prior income tax laws. It is our view that depreciation is allowed within the meaning of the statute when it is claimed by the taxpayer and not opposed by the Commissioner, even though the taxpayer has no net income which is offset thereby. We find nothing in the statute or regulations, *supra,* which supports the conclusion that a deduction can be treated as allowed only when it results in a tax advantage to the taxpayer. And in *Helvering v. State-Planters Bank & Trust Co.,* 130 F. 2d 44 (C.C.A. 4th), the court, approving G.C.M. 22,163, 1940-2 Cum. Bull. 76, held that amounts recovered in any taxable year upon debts previously charged off and allowed as a deduction should be treated as taxable income regardless of whether the prior allowance of the deduction resulted in a tax benefit to the taxpayer. That case certainly supports our position here and it has been followed by the Third Circuit in *Commissioner v.*

United States & International Securities Corp. (C.C. A. 3d), decided September 24, 1942 (1942 C.C.H., par. 9667). To the same effect see *Stearns Coal & Lumber Co. v. Glenn,* 42 F. Supp. 28 (W.D. Ky.), appeal to the Circuit Court of Appeals for the Sixth Circuit pending. Cf. also *National Bank of Commerce v. Commissioner,* 115 F. 2d 875 (C.C.A. 9th).

It is true that in *Pittsburgh Brewing Co. v. Commissioner,* 107 F. 2d 155 (C.C.A. 3d), the court took the view that depreciation is not allowed within the meaning of the statute[1] unless it is actually taken as a deduction against taxable income and that case was followed by the court below[2] but it is believed to be unsound and in substantial conflict with the *State-Planters Bank & Trust Co.* and *International Securities Corp.* cases, *supra.* See also *Beckridge Corp. v. Commissioner,* 129 F. 2d 318 (C.C.A. 2d). Attention is also invited to a note in 40 Columbia Law Review 540, where it is concluded that the *Pittsburgh Brewing Co.* case was erroneously decided.

Prior to the 1924 Act, there was no specific provision with respect to adjustment for depreciation in computing gain or loss from a sale of property, but the courts nevertheless held that the basis should be

---

[1]The statute there involved, Section 113 (b) (1) (B) of the Revenue Act of 1932, contains the same provisions as Section 113 (b) (1) (B) of the Revenue Acts of 1934 and 1936, here involved.

[2]The *Pittsburgh Brewing Co.* case was also followed in *Kennedy Laundry Co. v. Commissioner,* 46 B.T.A. 70, appeal to the Circuit Court of Appeals for the Seventh Circuit pending, and in *Virginian Hotel Corp. v. Commissioner,* decided May 6, 1942 (Prentice Hall B.T.A. Service, par. 42,268), appeal to the Circuit Court of Appeals for the Fourth Circuit pending.

reduced by the amount which was legally allowable in past years even though no such deduction was taken and no tax advantage would have resulted if it had been taken. *United States v. Ludey,* 274 U. S. 295; *Hardwick Realty Co. v. Commissioner,* 29 F. 2d 498 (C.C.A. 2d). The theory underlying these cases is that by using up property, a gradual sale is made of it. When the property is disposed of after years of use, the thing then sold is not the whole thing originally acquired. The amount of depreciation must be deducted from the original cost of the whole in order to determine the cost of that disposed of in the final sale. See *United States v. Ludey, supra,* p. 301. By Section 202 (b) of the Revenue Act of 1924, it was provided that in computing gain or loss, adjustment should be made for depreciation previously allowed. Section 202 (b) of the Revenue Act of 1926 is somewhat different; it provides for diminution of the basis by the amount of the deductions for depreciation which have since the acquisition of the property been allowable. That provision is also contained in Section 111 (b) (2) of the Revenue Act of 1928. In Section 113 (b) (1) (B) of the Revenue Act of 1932, the law was again changed so as to provide for adjustment for depreciation to the extent allowed (but not less than the amount allowable) under that Act or prior income tax laws. As hereinbefore noted, the same provision is contained in Section 113 (b) (1) (B) of the Revenue Acts of 1934 and 1936, here involved.[3] The reason for the 1932 change was to prevent a taxpayer who had

[3]All of these Revenue Acts from 1924 to 1936 have provided generally that the same basis shall be used for depreciation as for gain or loss. See Section 204 (c), Revenue Acts of 1924 and 1926, Section 114 (a), Revenue Acts of 1928, 1932, 1934 and 1936.

taken depreciation deductions over a period of years from claiming in a subsequent year that such deductions were excessive and that his basis should be reduced only by a lesser amount which was properly allowable.[4] If a taxpayer could do this, then he might obtain a double deduction which was not intended by Congress. But surely it does not follow that Congress meant to limit the adjustment to the amount actually deducted from taxable income. Clearly, the statute provides for adjustment in respect of the amount allowable, where that is greater than the amount al-

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[4]See S. Rep. No. 665, 72d Cong., 1st Sess., p. 29 (1939-1 Cum. Bull. (Part 2) 496, 517), as follows:

> In subparagraph (B), relating to depreciation, etc., for the period since February 28, 1913, the bill requires that adjustment be made "to the extent allowed (but not less than the amount allowable)" instead of "by the amount * * * allowable" as in the prior act. The Treasury has frequently encountered cases where a taxpayer, who has taken and been allowed depreciation deductions at a certain rate consistently over a period of years, later finds it to his advantage to claim that the allowances so made to him were excessive and that the amounts which were in fact "allowable" were much less. By this time the Government may be barred from collecting the additional taxes which would be due for the prior years upon the strength of the taxpayer's present contentions. The Treasury is obliged to rely very large upon the good faith and judgment of the taxpayer in the determination of the allowances for depreciation, since these are primarily matters of judgment and are governed by facts particularly within the knowledge of the taxpayer, and the Treasury should not be penalized for having approved the taxpayer's deductions. While the committee does not regard the existing law as countenancing any such inequitable results, it believes the new bill should specifically preclude any such possibility. Your committee has not thought it necessary to include any express provision against retroactive adjustments of depreciation on the part of the Treasury as the regulations of the Treasury seem adequate to protect the interests of taxpayer in such cases. These regulations require the depreciation allowances to be made from year to year in accordance with the then known facts and do not permit a retroactive change in these allowances by reason of the facts developed or ascertained after the years for which such allowances are made.

lowed, even though no deduction was ever claimed. *Beckridge Corp. v. Commissioner, supra; Herder v. Helvering,* 106 F. 2d 153 (App. D.C.), certiorari denied, 308 U. S. 617. And where, as here, the amount actually taken as deductions exceeds that properly allowable, then under the statute, the first amount must be used as the adjusting figure regardless of whether such deductions resulted in any tax advantage to the taxpayer. The statute is plain and unqualified and in the absence of an express provision to the contrary, we submit that it should be interpreted in conformity with the rule that a deduction is none the less allowed even though it results in no tax advantage to the taxpayer. *Helvering v. State-Planters Bank & Trust Co., supra.* Each taxable year must be regarded as an independent unit for income tax purposes (*Burnet v. Sanford & Brooks Co.,* 282 U. S. 359; *Burnet v. Thompson Oil & G. Co.,* 283 U. S. 301, 306), and it would be contrary to the spirit of that rule to permit a taxpayer to reduce his income for one year merely because he derived no tax advantage from a deduction taken in a previous year.

Moreover, it is erroneous to assume that a taxpayer derives no tax advantage from any particular deduction merely because he has no net income for the year in question. So long as he has some gross income, it can not be said that the deduction did not contribute to some extent at least in offsetting that income. In the instant case the taxpayer sustained losses in the years 1931-1933 during which it reported depreciation in excess of the amount properly allowable. But we submit that this is not sufficient to compel the conclusion that the depreciation deductions resulted in no

tax advantage for those years. See dissenting opinion of Member Disney in *Kennedy Laundry Co. v. Commissioner,* 46 B.T.A. 70, *supra.* The record does not contain the tax returns and we submit that the taxpayer has failed to sustain the burden of proving the absence of tax advantage, even if that should be considered material Cf. *Burnet v. Houston,* 283 U. S. 223.

Furthermore, there would be administrative difficulties in applying the rule approved by the court below. See *Helvering v. State-Planters Bank & Trust Co., supra,* where in an analogous situation the court said (p. 48):

> To apply the rule contended for by taxpayer would, we think, result in great confusion and complication in this particular branch of the tax law. What would be the rule where the charge off has resulted in tax benefit only to the extent of a portion of the debt? What, where other deductions are involved which, together with the deduction of the debt, result in no taxable income? What of the situation where, because of difference in tax rate, the tax benefit from the deduction does not equal the amount of the tax arising from the collection? The rule which we think is the correct one presents no such difficulties and is logically unassailable. The taxpayer is bound by the election which he has made in charging the debt off and deducting it as worthless in his return. There is no occasion to inquire whether this has resulted in tax benefit, for the matter under consideration is the income of a subsequent year.

Where a taxpayer has gross income and the depreciation item is only one of several items comprising

the total deductions which were taken into consideration in determining a net loss, it is difficult to see any ground for concluding that the depreciation resulted in no tax advantage, unless it be to the small fractional extent resulting from apportioning net loss in the ratio of depreciation to total deductions. See dissenting opinion of Member Disney in *Kennedy Laundry Co.* case, *supra.*

In the light of these considerations, we submit that there is no occasion to inquire whether the deductions in question resulted in tax benefit. They were claimed by the taxpayer, allowed by the Commissioner and under the specific language of the statute, the amount thereof should be applied against the basis for future depreciation deductions.

CONCLUSION.

The judgment of the court below should be reversed.

Dated, November 6, 1942.

Respectfully submitted,

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Attorneys for Appellant.

No. 10,206.

IN THE

14

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

UNITED STATES OF AMERICA,

Appellant,

vs.

DON LEE, INC.,

Appellee.

On Appeal From the District Court of the United States for the Northern District of California, Southern Division

---

BRIEF FOR DON LEE, INC., APPELLEE.

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STATUTES.

No. 10,206.

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

UNITED STATES OF AMERICA,

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vs.

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Appellee.

On Appeal From the District Court of the United States for the Northern District of California, Southern Division

---

BRIEF FOR DON LEE, INC., APPELLEE.

Jurisdiction.

This is an action to recover income and excess profits taxes alleged to have been erroneously and illegally collected by the United States [R. 2]. The jurisdiction of the District Court is sustained by Section 24 (20) of the Judicial Code, as amended; and that of the Circuit Court by Section 128 (a) of the Judicial Code, as amended. The taxpayer was at all times concerned a corporation organized under the laws of California, with an office in San Francisco. Claims for refund of the taxes alleged to have been illegally and erroneously collected were filed on June 26, 1940, and were rejected by the Commissioner of Internal Revenue on January 25, 1941. The complaint was filed on May 7, 1941. Judgment of the District

Court was entered March 30, 1942, in favor of the taxpayer. Notice of appeal was filed by the United States on May 27, 1942.

Question Presented.

Where the taxpayer reports excessive depreciation of property for the years 1931, 1932 and 1933, but does not benefit from such depreciation by an offset against taxable income for these years because of business losses, should that portion of the depreciation beyond the amount legally allowable be added back to the basis of the property for computing depreciation for the years 1935 and 1936?

Statement.

The case was submitted to the District Court for decision upon the stipulation of facts and the pleadings [R. 10-14, 21]. Appellant's statement of the case sets forth substantially the said stipulated facts, and, therefore, no separate statement is made herein.

Summary of Argument.

The basis of property for depreciation is the cost thereof reduced by the amount of depreciation allowed (but not less than the amount allowable) in previous years. To constitute "allowed" within the meaning of Section 113(b)(1)(B) of the Revenue Acts of 1934 and 1936, the amount of depreciation in excess of that legally allowable must reduce taxable income. Therefore, the excess of depreciation which was reported by the taxpayer in prior years over that legally allowable, to the extent that such excess depreciation did not offset taxable income in those years, should be added back to the basis for computing depreciation of the taxpayer's property in subsequent years.

ARGUMENT.

The Taxpayer's Basis Should Be Increased by the Excess of Depreciation Reported in Prior Years Over the Amount Legally Allowable, to the Extent That Such Excess Does Not Offset Taxable Income.

The taxpayer relies upon the following statutes:

Revenue Act of 1934, c. 277, 48 Stat. 680, and Revenue Act of 1936, c. 690, 49 Stat. 1648:

> "Sec. 23. Deductions from Gross Income.
>
> In computing net income there shall be allowed as deductions:
>
> * * * * * * * * *
>
> (l) Depreciation.—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * *
>
> * * * * * * * * *
>
> (n) Basis for Depreciation and Depletion.—The basis upon which depletion, exaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114."

> "Sec. 113. Adjusted Basis for Determining Gain or Loss.
>
> (a) Basis (unadjusted) of property.—The basis of property shall be the cost of such property; * * *
>
> * * * * * * * * *
>
> (b) Adjusted basis.—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) General Rule.—Proper adjustment in respect of the property shall in all cases be made—

* * * * * * * * *

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws. * * *"

"Sec. 114. Basis for Depreciation and Depletion.

(a) Basis for depreciation.—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in Section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property."

In the instant case there is no dispute that the taxpayer was the owner of depreciable property or as to the cost thereof [R. 4-5]. The only point at issue is the *basis* upon which the depreciation should be computed. In order to arrive at the basis upon which depreciation should be computed under the above provisions of the Revenue Acts, it is necessary to decrease the cost by the amount of depreciation theretofore allowed but not less than the amount allowable. The Commissioner of Internal Revenue determined that the taxpayer's depreciable properties had a normal and useful life of fifteen years from acquisition and taxpayer agrees with the Commissioner in this regard [R. 13]. Depreciation computed on the fifteen-year life rate would therefore be the amount "allowable", and it would follow that depreciation computed on a ten-year life rate as was used by the taxpayer in the years 1931, 1932 and 1933 was in excess of the amount allowable.

That portion of the depreciation reported by the taxpayer in its income tax returns for 1931, 1932 and 1933 in excess of the amount allowable cannot be regarded as having been "allowed", in view of the fact that the taxpayer sustained during each of those years operating losses which, in fact, exceeded the depreciation reported [R. 13]. This point was considered in the case of *Pittsburgh Brewing Co. v. Commissioner,* 107 F. (2d) 155 (C. C. A. 3d), wherein it was held that depreciation was not "allowed" merely because it was deducted; it was also necessary that it should have reduced taxable income. We quote from the opinion of the Court:

> "Briefly stated, the question for our determination is whether depreciation claimed by the taxpayer in its income tax returns in amounts in excess of those legally allowable, have been 'allowed' within the meaning of the first sentence of Clause (B) of Sec. 113(b)(1), although no taxable income was offset thereby. To put it in another way, is depreciation 'allowed' only if it is actually deducted from taxable income or must it also be considered as 'allowed' if it is reported on an income tax return but not taken as a deduction because of insufficiency of income? After full consideration of this question we have reached the conclusion that depreciation is not 'allowed' within the meaning of the act unless it is actually taken as a deduction against taxable income.
>
> 'Allow' is defined as 'To grant (something) as a deduction or an addition; esp., to abate or deduct; as, to allow a sum for leakage.' Webster's New International Dictionary, 2d Ed., p. 70, def. 5. 'Allowed in the statute accordingly means granted as a deduction. Deduction is defined as 'That which is deducted; the part taken away; abatement; as a deduction from

> the yearly rent.' Webster's New International Dictionary, 2d Ed., p. 284, def. 2 b. It is the subtrahend in the process of subtraction. Obviously a minuend is necessary to the process. In the case before us the subtrahend is the depreciation and the minuend is the taxable income. If the minuend income is absent it follows that there can be no deduction and consequently no allowance within the meaning of the act."

Since the taxpayer sustained losses during the years 1931, 1932 and 1933 which exceeded the depreciation, the *excess* of depreciation reported for those years over the amount legally allowable cannot be deemed to have been "allowed" in view of the authority of *Pittsburgh Brewing Co. v. Commissioner, supra.*

That case was followed by the court below, and also by the Board of Tax Appeals in the following cases:

Kennedy Laundry Co. v. Commissioner, 46 B. T. A. 70, appeal to Circuit Court of Appeals for the Seventh Circuit pending;

Virginian Hotel Corp. of Lynchburg v. Commissioner, decided May 6, 1942, Prentice-Hall B. T. A. Service, par. 42,268, appeal to the Circuit Court of Appeals for the Fourth Circuit pending;

The Mosler Safe Co. v. Commissioner, decided September 9, 1942, Prentice-Hall B. T. A. Memo. Dec. par. 42,501.

All of the above are "depreciation" cases, involving the adjustment of the basis of property by adding back the excessive amount of depreciation reported in earlier years when the taxpayer derived no tax advantage because of losses sustained.

We find no case which holds contrary to the rule announced in the *Pittsburgh Brewing Co.* case and followed in all subsequent Board of Tax Appeals decisions involving the same question, nor has appellant cited any in its brief.

Appellant is not in agreement with the view on this matter of the Circuit Court of Appeals for the Third Circuit or of the Board of Tax Appeals in the cases cited above, or of the Court below in the case at bar; but contends that depreciation is allowed within the meaning of the statute when it is claimed by the taxpayer and not opposed by the Commissioner, even though the taxpayer has no net income which is offset thereby. Appellant concludes that the view of the Court in the *Pittsburgh Brewing Co.* case, *supra,* is in conflict with the following cases:

Helvering v. State-Planters Bank & Trust Co., 130 F. (2d) 44;

Commissioner v. United States & International Securities Corp., decided September 24, 1942 (1942 C. C. H., par. 9667);

Stearns Coal & Lumber Co. v. Glenn, 42 F. Supp. 28 (W. D. Ky.), appeal to the Circuit Court of Appeals for the Sixth Circuit pending;

National Bank of Commerce v. Commissioner, 115 F. (2d) 875 (C. C. A. 9th).

These cases cited by appellant are all "bad debt" cases, involving the treatment of amounts recovered upon debts charged off in prior loss years. They are ruled by entirely different provisions of the statutes and regulations, concerning gross income, bad debts and recoveries thereof; and are not concerned with the construction of the sec-

tions of the law on depreciation and the basis of property for depreciation.

It should be pointed out further with respect to the "bad debt" cases, that the House of Representatives Ways and Means Committee in its report on the Revenue Bill of 1942 (H. R. Rep. No. 2333, 77th Cong., 2d Session, p. 116; 1942 Internal Revenue Bull. No. 43, Oct. 26, 1942, pp. 17, 54) comments as follows:

> "There is at present considerable confusion as to the state of the law regarding the recovery of bad debts or taxes which have been taken as deductions in previous years. The confusion has arisen as to whether the taxation of the amount of the bad debt or tax recovered in the year of such recovery depends upon the tax benefit which the taxpayer derived from the deduction of those items in a prior year.
>
> The bill settled this question by excluding from the gross income of the taxpayer in the year of the recovery the amounts recovered to the extent that the debt or tax did not in any prior taxable year reduce his income tax liability. * * *"

The Revenue Act of 1942 (Sec. 116) clarifies the law relative to bad debt recoveries by an express provision, made retroactive to all taxable years, excluding such recoveries from income where the debt was charged off in a prior loss year to the extent that tax liability was not reduced thereby.

We submit, therefore, as to the aforementioned cases cited by appellant, first, that they are not in point because they involve the construction of entirely different sections of the statute, and second, that the rule involved in those cases cannot be regarded as the correct interpretation of

the law or as an expression of the intent of Congress in view of the aforesaid Committee Report, *supra,* and Sec. 116 of the Revenue Act of 1942. Moreover, in none of the said cases did the Court draw any analogy between the bad debt provisions of the law and the depreciation sections of the law.

Appellant points out that, although there was no specific provision prior to the 1924 Act with respect to adjustment for depreciation in computing gain or loss from a sale of property, the courts have held the basis should be reduced by the amount which was legally allowable in past years even though no such deduction was taken and no tax advantage would have resulted if it had been taken. With this point and the authorities cited to support it (*United States v. Ludley,* 274 U. S. 295; *Hardwick Realty Co. v. Commissioner,* 29 F. (2d) 498 (C. C. A. 2d), we are in full accord. So also are we in agreement with the authorities cited by appellant (namely, *Beckridge Corp. v. Commissioner,* 129 F. (2d) 318; *Herder v. Helvering,* 106 F. (2d) 153) to the effect that the statute provides for adjustment in respect of the allowable depreciation, where that is greater than the amount allowed, even though no deduction was ever claimed.

The rule of the *Pittsburgh Brewing Co.* case, *supra,* does not apply where the prior deduction was allowable. (*Lehman v. Commissioner,* decided October 1, 1942. Prentice-Hall B. T. A. Memo Service, par. 42,540. The taxpayer should report in each taxable year the amount of depreciation to which he is entitled (*U. S. v. Ludley, supra*), i. e., the amount "allowable." If he reports less than the amount allowable or none at all, the basis for future depreciation must nevertheless be reduced by the

full amount of depreciation allowable in previous years. The statute defines the minimum adjustment for depreciation as the amount allowable. If, however, the taxpayer reports depreciation in excess of the amount legally allowable, then the rule of the *Pittsburgh Brewing Co.* case applies and the excess depreciation is deemed allowed to the extent that it reduces taxable income. The court in the *Pittsburgh Brewing Co.* case fully considered the intent of Congress and, after examining into the legislative history of the pertinent provisions and the House Ways and Means Committee report there, concludes:

> "Obviously the Committee referred to the situation in which a taxpayer, having had the benefit of a larger depreciation deduction from gross income than was properly allowable to him, claims upon the sale of the depreciated property that his sale basis should be increased by deducting only the smaller depreciation properly allowable, thus gaining a double deduction against taxable income. We think it clear that it was to prevent the probability of such a double deduction that the provisions of the Revenue Act of 1932 [identical with the corresponding provisions of the Revenue Acts of 1934 and 1936] which we are considering were enacted. No double benefit can be received where, as in the case before us, the depreciation originally claimed offsets no taxable income which would otherwise have been taxable."

Appellant invites attention to a Columbia Law Review article (40 Columbia Law Review 540) where it is concluded that the *Pittsburgh Brewing Co.* case was erroneously decided. In that article the author was under the erroneous impression that the court had decided, contrary to law, that the basis should not, under any circum-

stances, be reduced by depreciation unless the taxpayer actually received the benefit thereof as a deduction from taxable income, whereas in fact, as was pointed out above, the doctrine of the *Pittsburgh Brewing Co.* case applies only to the amount of depreciation *in excess* of that legally allowable.

Appellant has cited three other cases not heretofore discussed in this brief. Two of them deal with the rule that each taxable year must be regarded as an independent unit for income tax purposes. (*Burnet v. Sanford & Brooks Co.,* 282 U. S. 359; *Burnet v. Thompson Oil & G. Co.,* 283 U. S. 301, 306.) Again, we do not dispute the rule, but contend that it has no application to the issue involved in the case at bar. Appellant states that it would be contrary to that rule to permit a taxpayer to reduce his income for one year merely because he derived no tax advantage from a deduction taken in a previous year. That is not our contention. Rather, we are here concerned with the rule for correctly determining the basis as of a given date on which to compute depreciation subsequent thereto, and in this regard the statutes and regulations cited in both the appellant's and our briefs prescribe the method for arriving at the correct basis, which is to decrease the original cost by the amount of depreciation theretofore "allowed", but not less than the amount "allowable". If a taxpayer failed to deduct the full amount of depreciation allowable in any year, such taxpayer would nevertheless be required to use as a basis for depreciation in subsequent years the cost reduced by the full amount of allowable depreciation. On the other hand, if the taxpayer deducted depreciation in excess of the amount allowable, and benefited from such excessive depreciation through reduction of taxable income, then the

basis for depreciation in subsequent years would be the cost less depreciation actually deducted even though in excess of the amount allowable. The third situation, which is that obtaining in the instant case, is where a taxpayer reports depreciation for prior years in excess of the amount legally allowable and does not benefit because there was no taxable income offset thereby. The basis for depreciation in subsequent years would be the cost reduced by the amount of depreciation allowable rather than the amount actually reported.

The remaining case mentioned by appellant but not heretofore discussed in this brief is *Burnet v. Houston,* 283 U. S. 223, cited in connection with appellant's contention that the taxpayer has failed to sustain the burden of proving the absence of tax advantage because the record does not contain the tax returns. It will be recalled that this case was submitted to the District Court for decision upon the stipulation of facts and the pleadings. The taxpayer in its complaint alleged that in the years 1931, 1932 and 1933, and each of them, it sustained operating losses; losses for each said year being in excess of the depreciation reported in each such year [R. 3], and appellant in its answer admitted that the taxpayer *in its returns* for 1931, 1932 and 1933 claimed and reported operating losses which were in excess of the amount of depreciation reported for each of said years [R. 8]. Furthermore, the parties stipulated that the taxpayer sustained operating losses during the years 1931, 1932 and 1933 which, in fact, exceeded the depreciation

reported [R. 13]. The agreed statement of facts, therefore, obviated the necessity for establishing the individual expense items and other deductions authorized by law which in the aggregate, exclusive of the deduction for depreciation, exceeded the taxpayer's gross income reported in its income tax returns for each of the years 1931, 1932 and 1933. Since the stipulation that there were losses could mean only that the expenses exceeded the gross income, we submit that it is now an undisputed fact that the taxpayer did not receive a tax advantage by reason of the excessive depreciation reported.

Finally, appellant maintains that it is erroneous to assume that a taxpayer derives no tax advantage from any particular deduction merely because he has no net income for the year in question; and, further, that there would be administrative difficulties in applying the rule approved by the court below. In support of the former contention, appellant cites the dissenting opinion in *Kennedy Laundry Co. v. Commissioner, supra.* The Board of Tax Appeals in that case followed the rule announced in the *Pittsburgh Brewing Co.* case. We submit that the reasoning of the dissenting opinion as well as the comment of the court in *Helvering v. State-Planters Bank & Trust Co., supra,* in support of appellant's latter contention, cannot be given current weight in view of the expression of legislative intent announced in connection with the enactment of Section 116 of the Revenue Act of 1942, to exclude bad debt recoveries from income where the debt was charged off in a prior tax year to the extent that tax

liability was not reduced thereby. Congress has thus nullified and overcome the objections raised by appellant relative to the tax benefit theory by expressly approving it as to recovery of bad debts, prior taxes, and delinquency amounts. It has been shown above that this action was taken by Congress to eliminate the confusion existing in the state of the law regarding the recovery of bad debts or taxes which had been taken as deductions in previous loss years.

In view of the foregoing, it is submitted that the basis of the taxpayer's property should be adjusted by adding back the excess of depreciation reported in prior loss years over the amount legally allowable, since the excess did not offset any taxable income.

Conclusion.

The judgment of the court below should be affirmed.

Dated: December 16, 1942.

Respectfully submitted,

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Attorneys for Appellee.

No. 10211

United States
Circuit Court of Appeals

For the Ninth Circuit.

JAMES NATHAN LOWERY,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

Transcript of Record

Upon Appeal from the District Court of the United States for the Western District of Washington, Northern Division

ROTARY COLORPRINT, 590 FOLSOM ST., SAN FRANCISCO

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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United States District Court
Western District of Washington
Northern Division
May, 1942, Term

No. 45709

UNITED STATES OF AMERICA,
Plaintiff,

vs.

JAMES NATHAN LOWERY,
Defendant.

INDICTMENT

(Sec. 2553a Internal Revenue Code)

Vio. Act of Dec. 17, 1914, as amended, and
Vio. Narcotic Drugs Import and Export Act.

(Sec. 174, Title 21, U.S.C.A.)

United States of America
Western District of Washington
Northern Division—ss.

The grand jurors of the United States of America, being duly selected, impaneled, sworn and charged to inquire within and for the Northern Division of the Western District of Washington, upon their oaths present: [1*]

Count I.

(2553a I.R.C.—possession)

That James Nathan Lowery on the twenty-ninth

*Page numbering appearing at foot of page of original Transcript of Record.

day of March, in the year of Our Lord One Thousand Nine Hundred Forty-two, at the City of Seattle, in the Northern Division of the Western District of Washington, and within the jurisdiction of this Court, then and there being, did then and there knowingly, willfully, unlawfully, and feloniously, and not in the original stamped package, nor from the original stamped package, purchase sell, dispense and distribute a quantity, to wit: Fifty (50) ounces of a certain compound, manufacture, salt, derivative, and preparation of Opium, to wit: Opium Prepared for Smoking; contrary to the form of the statute in such case made and provided, and against the peace and dignity of the United States of America. [2]

And the grand jurors aforesaid, upon their oaths aforesaid, do further present:

Count II.
(174—21)

That James Nathan Lowery, hereinafter called the defendant, to wit: On or about the twenty-ninth day of March, 1942, at the City of Seattle, County of King, in the Northern Division of the Western District of Washington, and within the jurisdiction of this Honorable Court, then and there being, did then and there violate the Act of February 9, 1909, as amended by the Act of May 26, 1922, in that he, the said defendant, did then and there willfully, unlawfully, knowingly, feloniously and fraudulently receive, conceal, buy, sell and facilitate the transportation and concealment

after importation of a certain derivative and preparation of Opium, to wit: Fifty (50) ounces of Opium Prepared for Smoking, which said preparation of opium, as the defendant then and there well knew had been imported into the United States contrary to law.

Against the peace and dignity of the United States of America and contrary to the form of the statute of the United States of America in such case made and provided.

J. CHARLES DENNIS
United States Attorney.
G. D. HILE
Assistant United States
Attorney. [3]

[Endorsed]: A true bill.

WENDELL P. HURLBUT,
Foreman

Bail, $.....
J. CHARLES DENNIS

[Endorsed]: Presented to the Court by the Foreman of the Grand Jury in open Court, in the presence of the Grand Jury, and Filed in the U. S. District Court May 27, 1942.

JUDSON W. SHORETT,
Clerk
By LEE L. BRUFF,
Deputy. [3a]

[Title of District Court and Cause.]

PLEA—TRIAL DATE SET

Now on this 6th day of June, 1942, Gerald Shucklin, Asst. U. S. Attorney appearing for the Government and Albert D. Rosellini, attorney for the defendant appearing, this matter comes on before the Court for arraignment and taking the plea of defendant. The defendant is present in Court with his counsel, and declares his true name to be James Nathan Lowery. Defendant waives the reading of the Indictment. Defendant enters a plea of not guilty to Count I, as charged in the indictment. Defendant enters a plea of not guilty to Count II as charged in the indictment. Case set for trial June 30, 1942 at 10:00 A.M., end of calendar, for jury cases. [4]

[Title of District Court and Cause.]

MOTION AND AFFIDAVIT FOR SUPPRESSION OF EVIDENCE

State Comes Now the defendant above named and moves the Court for an order suppressing certain exhibits and evidence now improperly held by agents of the United States Treasury Department, Narcotics Division.

This motion is based upon the affidavits of Al-

bert D. Rosellini and James Nathan Lowery attached hereto.

ALBERT D. ROSELLINI
Attorney for Defendant

State of Washington:
County of King—ss.

Albert D. Rosellini, being first duly sworn, upon oath deposes and says: That he is the attorney for the defendant above named, and that he has consulted with said defendant, and investigated the facts in connection with the arrest of said defendant. That said arrest is illegal and that the exhibits and evidence secured from said defendant were illegally obtained by Narcotics Agents in that said Narcotic Agents did not have a search warrant or any other writ authorizing them to search the defendant, James Nathan Lowery, or any of his personal belongings, and that said agents did not have, and could not have had, any knowledge or information of the commission of any crime by the defendant James Nathan Lowery. That the defendant James Nathan Lowery was not committing any crime in their presence, and that the Narcotic Agents did not have any information concerning the possession of any narcotics or any [5] other property taxable under the United States laws, and that said search and seizure of the de-

fendant was in violation of the United States Federal Constitution, Articles V and XIV.

ALBERT D. ROSELLINI

Subscribed and sworn to before me this 30th day of June, 1942.

[Seal] THOS. MARSHALL

Notary Public in and for the State of Washington, residing at Seattle.

[Endorsed]: Filed Jul. 3, 1942. [6]

[Title of District Court and Cause.]

AFFIDAVIT OF JAMES NATHAN LOWERY

State of Washington
County of King—ss.

James Nathan Lowery, being first duly sworn, upon oath deposes and says: That he is the defendant in the above entitled action; that he is a resident of Seattle, King County, Washington; that at no time has he been convicted of any felonies. That the only convictions against him are two gambling charges on which he received fines of $25.00 and $50.00 respectively. That on March 30, 1942, about 1 o'clock A. M., he arrived at Boeing Field in the City of Seattle, on an airplane. That on getting off the plane, he took his grip and walked to the Boeing cab and handed the grip

to the cab driver. That at said time, three men came up to him and one of the men said, "F.B.I. narcotic agents, Sunny". That said party flashed a badge. That said men took his grip and led him away to their car, and took him to the Federal Court House, where his grip was opened. That at the time that the officers told him they were F.B.I. agents, affiant felt that he was under arrest, and was led away to the car under their custody. While in the car one agent asked affiant "How much have you in the bag". Affiant answered, "Ten." That affiant at no time went willingly with the officers, but he was given the impression that he was under arrest at the [7] *the* officers took his grip and told him they were F.B.I. agents. That said agents did not have a search warrant or any other warrant or writ authorizing them to search affiant or any of his belongings. That said agents did not have, and could not have had, any knowledge or information of the commission of any crime by affiant. That affiant was not committing any crime in the presence of said agents, and said agents did not have, nor could have had, any information concerning the possession of any narcotics or any other property taxable under the United States laws, and that said search and seizure of the defendant and his personal belongings was unreasonable and unlawful. Affiant came to Seattle in August, 1941, and left Seattle only twice, to-wit: November, 1941, to go to Montana for his

divorce, and again in January to go to Montana for his divorce.

JAMES NATHAN LOWERY

Subscribed and sworn to before me this 3rd day of July, 1942.

[Seal] ALBERT D. ROSELLINI
Notary Public in and for the State of Washington, residing at Seattle.

[Endorsed]: Filed Jul. 3, 1942. [8]

[Title of District Court and Cause.]

AFFIDAVIT IN OPPOSITION TO DEFENDANT'S MOTION TO SUPPRESS

United States of America
Western District of Washington
Northern Division—ss.

Donald R. Smith, being first duly sworn, on oath deposes and says: That he is a Narcotic Agent, United States Bureau of Narcotics, Treasury Department, stationed at Seattle, Washington, and that he makes this affidavit on behalf of the United States in opposition to defendant's motion to suppress evidence.

That affiant is familiar with the records and correspondence in the office of the Bureau of Narcotics at Seattle, Washington; that prior to the acts herein related he reviewed a letter in the files

of said Bureau received from the San Francisco office of the Bureau of Narcotics dated June 11, 1941, at Los Angeles, that the said defendant James Nathan Lowery was believed to be trafficking in drugs between California and Montana; that affiant knew that the said defendant resided in this district for approximately the past year.

That your affiant, while acting in his capacity as Narcotic Agent, received information which he believed and does believe was reliable from a confidential source upon [9] whom affiant depended in the past and whose information on prior occasions had been correct, that the defendant James Nathan Lowery had received a letter from one Tony Alvarado, living at F29 1a, 729 Ugarto, City of Juarex, State of Chihuahua, Mexico, and that the letter stated in effect the following:

> "How are you?
>
> I got your letter today. My wife went to get it. Don't come until you get tela. with price and everything. Price no trouble, I want to keep friendship"
>
> Signed "TONY".

and that said confidential source disclosed that the said James Nathan Lowery was going to make a trip South to obtain opium and that he would probably go by airplane. This was in March, 1942.

This same confidential source advised affiant on March 24, 1942, that the defendant James Nathan Lowery received a telegram from the said Tony

Alvarado, signed "Tony", which came from Mexico and stated as follows:

> "I have ten carates good quality. Answer if you will come.
>
> TONY".

Your affiant checked the Spanish definition of the word "carates" and found that it meant "liver spots or brown spots"; your affiant deduced from this that the said word was a code word between the correspondents meaning opium.

Your affiant through his investigation discovered that the defendant under the name of James Smith departed from Seattle by plane at 8:45 P.M. March 26, 1942, for El Paso, Texas, on a round-trip ticket; that El Paso, Texas, is just across the international border from Juarez, Mexico, the place where the telegram and letter came from. Affiant received information from the United Air Lines that the defendant James Nathan Lowery was booked for a return trip by [10] plane, which was scheduled to arrive at 12:10 on the morning of March 29, 1942, and which actually arrived at 12:55 that day.

In company with Narcotic Agent Henry L. Giordano, I went to Boeing Field Airport about the time of the arrival of the plane. I had previously seen Lowery and could recognize him. I saw him leave the plane, claim his baggage and proceed to the Air Lines limousine which carries passengers into the city. As Lowery took the bag which he was carrying over to the limousine, Narcotic Agent

Hain said "We are Federal Officers" and took the bag from the driver of the limousine, and Lowery voluntarily went with Hain, Narcotic Agent Giordano and Detective Lieutenant Belland of the Police Department and affiant over to the automobile of the Narcotic Bureau. In the car were the defendant Lowery, Agents Hain and Giordano and Detective Lieutenant Belland. Affiant then left and drove to the Narcotic Bureau office in the United States Court House. In the office, in the presence of District Supervisor A. M. Bangs of the Narcotic Bureau, and Detective Lieutenant Belland and Agents Hain and Giordano, the defendant opened his bag and handed me ten cans of smoking opium, seven cans were in a shaving kit and three were in a newspaper. The defendant Lowery stated that he obtained the opium in El Paso, Texas, for $650.00.

(Signed) DONALD R. SMITH

Subscribed and sworn to before me this 2d day of July, 1942.

(Signed) TRUMAN EGGER

Deputy Clerk, U. S. District Court, Western District of Washington.

Copy of within received Jul. 3, 1942.

ALBERT D. ROSELLINI

M

[Endorsed]: Filed Jul. 3, 1942. [11]

[Title of District Court and Cause.]

AFFIDAVIT IN OPPOSITION TO DEFENDANT'S MOTION TO SUPPRESS

United States of America
Western District of Washington
Northern Division—ss.

A. M. Bangs, being first duly sworn, on oath deposes and says: That he is District Supervisor, Bureau of Narcotics, U. S. Treasury Department, at Seattle, Washington, for the states of Washington, Oregon, Idaho, Montana and Alaska, and that he makes this affidavit on behalf of the United States in opposition to defendant's motion to suppress evidence.

That I first learned about the defendant James Nathan Lowery in my official capacity in June, 1941, when I received an official letter from the San Francisco Narcotic office advising that an investigation conducted in Los Angeles, California, had very definitely indicated James Nathan Lowery to be engaged in narcotic activities between California and Montana, particularly Great Falls. I subsequently caused an investigation to be made in Great Falls by the Narcotic Officers stationed in Montana, and was advised as a result of that investigation that Lowery had been in Great Falls, Montana, but had departed and was believed to be in Seattle; subsequently, personal investigations and investigations by [12] officers working under my direction revealed that James Nathan Lowery

had come to Seattle about August, 1941, from Great Falls, and that he was making occasional trips away from Seattle and on such occasions it was generally believed by the persons with whom I discussed the matter, that he had gone to Southern California, Salt Lake City or Phoenix, Arizona, for narcotic drugs.

Late in January or early February, 1942, I learned from another source which I believe to be reliable, that this source believed himself to be in position to advise me when "Sunny" Lowery, as he was known to him, left Seattle for the South for the purpose of bringing back to Seattle smoking opium. That a short while later, Agent, Smith, whom I had assigned to work with this confidential source, advised me that the source had turned over to him excerpts of a letter which he, the source, had seen in the possession of Sunny Lowery; the excerpts read as follows:

> "How are you?
>
> I got your *your* letter today. My wife went to get it. Don't come until you get tela. with price and everything. Price no trouble, I want to keep friendship."
>
> (Signed) "TONY".

Agent Smith delivered this excerpt to me and within the next two or three days I personally discussed this development with the confidential source, and he advised me that it was his belief that Sunny Lowery would very shortly depart for either El Paso or Juarez, Mexico, for the opium

which he assumed the writer was to obtain, and would probably go by airplane. This was early in March, 1942.

Later in March, about the 22d, I learned from the same confidential source and Agent Smith that Sunny Lowery had received a telegram from Juarez, Mexico, reading sub- [13] stantially as follows:

> "I have ten carates good quality. Answer if you will come.
>
> TONY".

After a thorough discussion with the confidential source, I concluded that Sunny Lowery would shortly depart from Seattle and in anticipation of what I contacted the United Air Lines and instructed them to advise me in the event a colored male answering the general description which was furnished them booked passage for El Paso, Texas. On the evening of March 26th, I was advised by the United Air Lines that a colored male had departed from Boeing Air Field at 8:45 P.M., traveling under the name of James Smith, but that the Air Lines employees had noted that he carried a bag bearing the initials "J.N.L."; that this person was traveling on a return ticket to El Paso. On March 28th, I was again advised by the United Air Lines officials that James Smith was on his way back to Seattle and would, unless he made different connections than originally planned, arrive in Seattle Sunday morning at 8:10 A.M. Because of the information from the Air

Lines Company, it was deemed advisable to cover all planes arriving in Seattle from Southern California beginning at 8:00 P.M. March 28, 1942. Pursuant to my instructions, Narcotic Agents Hain, Giordano and Smith and Detective Lieutenant Belland of the Police Department, covered the arrival of the air plane from Southern California at 8:00 P.M. and again at my direction, they covered the airplane which was scheduled to arrive at Boeing Air Field at 12:10 A.M. March 29, 1942. Shortly before 1:00 o'clock on the last mentioned date, I received a telephone call from Detective Belland advising me that they would shortly be in the office with Sunny Lowery. I immediately proceeded to the Narcotic Office [14] and there met the above named officers and the defendant herein. After preliminary greetings, I asked the defendant where he had been, to which he shrugged his shoulders and replied "Well, you know where I have been, you know all about it, why ask me." I then asked him what he had brought back with him, to which he replied "Ten cans" again shrugging his shoulders. I then asked him "Ten cans of What?" and he finally stated "Opium." Upon which he proceeded to open his bag and produced therefrom a shaving kit containing seven brass cans of opium and a newspaper package which he unwrapped and in which was found three tin cans of opium prepared for smoking. He was thereafter questioned and stated, among other things, that he had left Seattle forty-eight hours before, gone to El Paso,

Texas, and there contacted a Mexican known to him as "Albatross"; that the said Albatross had subsequently delivered to him on a street corner in El Paso, Texas, the ten cans of smoking opium in return for $650.00, same being according to him at the rate of $65.00 per tin.

(Signed) A. M. BANGS

Subscribed and sworn to before me this 3d day of July, 1942.

[Seal] (Signed) TRUMAN EGGER
Deputy Clerk, U. S. District Court, Western District of Washington.

Copy of within received Jul. 3, 1942 p. m.
ALBERT D. ROSELLINI

[Endorsed]: Filed Jul. 3, 1942. [15]

[Title of District Court and Cause.]

AFFIDAVIT IN OPPOSITION TO DEFENDANT'S MOTION TO SUPPRESS

United States of America
Western District of Washington
Northern Division—ss.

Gilbert T. Belland, being first duly sworn, on oath deposes and says: That he is a Detective Lieutenant with the Seattle Police Department, detailed with the Narcotic Squad, and that he makes this affidavit

on behalf of the United States in opposition to defendant's motion to suppress evidence.

That, having received reliable information from Agents of the Federal Narcotic Bureau in Seattle, affiant was assigned to cooperate with said officers in investigating the defendant James Nathan Lowery. Affiant received reliable information that the said defendant was in the act of transporting a quantity of opium from the Southern part of the United States to Seattle by plane and that the said defendant Lowery would arrive on the United *States* Air Lines plane at 12:10 A.M. March 29, 1942. The plane was late and arrived at 12:55 A.M. Affiant was with Narcotic Agent Martin Hain at the time; affiant saw defendant Lowery leave the plane, claim his baggage and proceed to the Air Lines limousine; Lowery turned his bag over to the driver of the [16] limousine, at which time Narcotic Agent Hain took the bag from the driver and gave the same to me, and Lowery went with Hain and myself to the car of the Narcotic Bureau. Present in the car were the defendant Lowery, Agents Hain and Giordano and affiant. Affiant placed the bag in the car. After we were in the car, Narcotic Agent Hain asked Lowery what he had in the bag. Lowery answered, "Well, you know what I have, I have the ten cans." We proceeded to the Narcotic Bureau office in the United States Court House; Giordano carried the bag into the Narcotic office. Present in the office were narcotic Agents Smith, Giordano and Hain, District Supervisor Bangs and affiant. Mr. Bangs asked Lowery

what he had in the bag, he said he had ten cans, Mr. Bangs asked "Ten cans of what?" Lowery answered "Opium." Lowery then opened the bag and took out ten cans of opium, seven of which were in a shaving kit and three in newspaper. Defendant admitted that he had obtained the ten cans of opium at El Paso, Texas, for $650.00.

Affiant, together with Narcotic Agent Hain, had been checking on said defendant Lowery since the receipt of a letter by the Seattle Narcotic Bureau office from San Francisco that the defendant had been engaged in trafficking narcotics from California to Montana.

(Signed) GILBERT T. BELLAND

Subscribed and sworn to before me this 2nd day of July, 1942.

[Seal]

(Signed) E. M. ROSSER
Deputy Clerk, U. S. District Court, Western District of Washington.

Copy of within received July 3, 1942.

ALBERT D. ROSELLINI
R M

[Endorsed]: Filed Jul. 3, 1942. [17]

[Title of District Court and Cause.]

AFFIDAVIT IN OPPOSITION TO DEFENDANT'S MOTION TO SUPPRESS

United States of America
Western District of Washington
Northern Division—ss.

Henry L. Giordano, being first duly sworn, on oath deposes and says: That he is a Narcotic Agent, United States Bureau of Narcotics, Treasury Department, stationed at Seattle, Washington, and that he makes this affidavit on behalf of the United States in opposition to defendant's motion to suppress evidence.

That affiant is familiar with the records and correspondence in the office of the Bureau of Narcotics at Seattle, Washington; that prior to the acts herein related he reviewed a letter in the files of said Bureau received from the San Francisco office of the Bureau of Narcotics dated June 11, 1941, at Los Angeles, that the said defendant James Nathan Lowery was believed to be trafficking in drugs between California and Montana; that affiant knew that the said defendant resided in this district for approximately the past year.

That your affiant, while acting in his capacity as Narcotic Agent, received information from Narcotic Agent Donald R. Smith that the James Nathan Lowery had received a [18] letter from one Tony Alvarado, living at F29 1a, 729 Ugarto, City of Juarez, state of Chihuahua, Mexico, and that the letter stated in effect the following:

"How are you?

I got your letter today, My wife went to get it. Don't come until you get tela, with price and everything. Price no trouble. I want to keep friendship."

(Signed) "TONY".

and that said Narcotic Agent Donald R. Smith disclosed to affiant that he understood from a reliable confidential sourece that the said James Nathan Lowery was going to make a trip South to obtain opium and that he would probably go by airplane. This was in March, 1942.

Narcotic Agent Smith also advised me that he received information from the same reliable confidential source that the defendant James Nathan Lowery received a telegram from the said Tony Alvarado, signed "Tony", which came from Mexico and stated as follows:

"I have ten carates good quality. Answer if you will come.

TONY".

Your affiant checked with Donald R. Smith the Spanish definition of the word "carates" and found that it meant "liver spots or brown spots", from which your affiant deduced that the said word was a code word between the correspondents meaning opium.

Your affiant through his investigation discovered that the defendant under the name of James Smith departed from Seattle, by plane at 8:45 P.M. March 26, 1942, for El Paso, Texas, on a round-trip ticket;

that El Paso, Texas, is just across the international border from Juarez, Mexico, the place where the telegram and letter came from. Affiant received information from the United Air Lines that the de- [19] fendant James Nathan Lowery was booked for a return trip by plane, which was scheduled to arrive at 12:10 on the morning of March 29, 1942, and which actually arrived at 12:55 that day.

In company with Narcotic Agent Donald R. Smith, I went to Boeing Field Airport about the time of the arrival of the plane; I saw the defendant Lowery leave the plane, claim his baggage and proceed to the Air Lines limousine which carries passengers into the city. As Lowery *tok* the bag which he was carrying over to the limousine, Narcotic Agent Hain said "We are Federal Officers" and took the bag from the driver of the limousine, and Lowery voluntarily went with Hain, Detective Lieutenant Belland of the Police Department, Donald R. Smith and affiant over to the automobile of the Narcotic Bureau. In the car were the defendant Lowery, Agent Hain, Detective Lieutenant Belland and affiant. Belland placed the bag in the car. After we were in the car, Narcotic Agent Hain asked Lowery what he had in the bag. Lowery answered, "Well, you know what I have," and Hain said "What have you?" Lowery answered "I have ten cans." We proceeded to the Narcotic Bureau office in the United States Court House: affiant carried the bag into the Narcotic office. Present in the office were Narcotic

Agents Smith and Hain, District Supervisor Bangs, Belland and affiant. Mr. Bangs asked Lowery what he had in the bag, he said he had ten cans, Mr. Bangs asked "Ten cans of what?". Lowery answered "Opium." Lowery then opened the bag and took out ten cans of opium, seven of which were in a shaving kit and three in a newspaper.

HENRY L. GIORDANO

Subscribed and sworn to before me this 3d day [20] of July, 1942.

[Seal] (Signed) TRUMAN EGGER
Deputy Clerk, U. S. District Court, Western District of Washington.

Copy of within received Jul. 3, 1942.
ALBERT D. ROSELLINI
M

[Endorsed]: Filed Jul. 3, 1942. [21]

[Title of District Court and Cause.]

WAIVER OF TRIAL BY JURY AND REQUEST FOR TRIAL BY COURT WITHOUT JURY

The undersigned James Nathan Lowery, defendant in the above entitled case, hereby voluntarily waives his right to trial by jury and respectfully requests that the Court try his cause without jury.

This waiver is made with the advice, consent and approval of my attorney Albert D. Rosellini.

Signed in open court this 6th day of July, 1942.

(Signed) JAMES NATHAN LOWERY

This Waiver is executed by the defendant James Nathan Lowery with my consent and approval.

(Signed) ALBERT D. ROSELLINI
Attorney for Defendant.

[Endorsed]: Filed Jul. 6, 1942. [22]

[Title of District Court and Cause.]

TRIAL

Now on this 6th day of July, 1942, this cause comes on before the Court for trial and for hearing on defendant's motion for suppression of evidence. This motion is called argued and denied. On oral motion of Albert Rosellini, attorney for defendant who appears in Court, leave is granted to file waiver for trial by Jury on behalf of the defendant. The Court enters an order accepting waiver for trial by jury and proceeds without assistance of the jury. After disposing of the motion to suppress the evidence, the case is called by the Court for trial. The parties announce ready. The defendant is present in court with his counsel Albert D. Rosellini and Gerald Shucklin, Assistant United States Attorney appears for the Government. Donald R. Smith is sworn and testifies on behalf of the Government. Plaintiff's

exhibits 1, 2 and 3 are marked for identification. At 3:50 P.M., Court recesses for ten minutes. At 4:00 P.M., Court is again in session, all are present as before and the trial is resumed. At 4:30 P.M., all parties are excused in this case until 2:00 P.M., Tuesday, July 7, 1942.

Tuesday, July 7, 1942
(Trial Resumed)

Now on this 7th day of July, 1942, this cause comes on before the Court for further trial. Gerald Shucklin, Assistant United States Attorney appears for the Government and Attorney Albert D. Rosellini appears for the defendant. [23] All parties are ready to proceed. The defendant is present with his counsel Albert Rosellini. Hugo Ringstrom is sworn and testifies for the Government. Plaintiff's Exhibits 1, 2 and 3 are admitted in evidence. Gilbert Belland, Henry Giordano and A. M. Bangs' testimony, the government moves to dismiss count I of the Indictment. No objections. Motion to dismiss count I granted. At 4:00 P.M., Government rests. The defendant, through his counsel, Albert Rosellini renews his motion to suppress the evidence. Motion denied. Mr. Rosellini moves to dismiss the case. Motion denied. The defendant offers no testimony and rests. The Court announces its oral decision, finds the defendant guilty on Count II. The court sets July 20, 1942 at 10:00 A.M. for time hearing any pending motions and for sentence. [24]

[Title of District Court and Cause.]

MOTION FOR NEW TRIAL

Comes Now the defendant, James Nathan Lowery, and moves the Court for judgment notwithstanding the oral decision of the Court, or, in the alternative, for a new trial, upon the following ground:

1. Irregularity in the proceedings of the Court and adverse party, or abuse of discretion by which the defendant was prevented from having a fair trial.
2. Misconduct of the prevailing party.
3. Accident and surprise which ordinary prudence could not have guarded against.
4. Newly discovered evidence material for the defendant, that could not have been discovered with reasonable diligence and produced at the trial.
5. Insufficiency of the evidence to justify the decision, or that it is against law.
6. Error of law occurring at the trial, and excepted to by the defendant.

Dated: July 9, 1942.

ALBERT D. ROSELLINI
Attorney for Defendant,
1111 Smith Tower,
Seattle, Washington.

Received a copy of the within motion this 9th day of July, 1942.

J. CHARLES DENNIS
Attorney

[Endorsed]: Filed Jul 9-1942. [25]

[Title of District Court and Cause.]

MOTION FOR DISMISSAL OF ACTION

Comes Now the defendant, James Nathan Lowery, and moves the Court for an order dismissing the above entitled cause, and all the proceedings therein, on the ground and for the reason that the indictment herein obtained and the trial of the cause herein are based upon an unlawful search and seizure of the person of the defendant, in violation of the Fourth and Fifth *Aments* of the United States Constitution, as is more fully set forth in the affidavits, files and records in this cause.

ALBERT D. ROSELLINI
Attorney for Defendant.

Received a copy of the within Motion this 9th day of July 1942.

J. CHARLES DENNIS
Attorney

[Endorsed]: Filed Jul 9-1942. [26]

[Title of District Court and Cause.]

MOTION FOR ARREST OF JUDGMENT AND STAY OF PROCEEDINGS

Comes Now the defendant, James Nathan Lowery, by and through his attorney, Albert D. Rosellini,

and moves the Court for an arrest of judgment and stay of proceedings in the above entitled cause.

This Motion is based upon the files and records herein.

ALBERT D. ROSELLINI
Attorney for Defendant.

Received a copy of the within Motion this 9th day of July 1942.

J. CHARLES DENNIS
Attorney for U. S.

[Endorsed]: Filed Jul 9-1942. [27]

[Title of District Court and Cause.]

SENTENCE PRONOUNCED

Now on this 20th day of July, 1942, this cause comes on before the Court for hearing on motion for arrest of judgment and stay of proceedings; motion of dismissal; motion for new trial; and sentence of defendant. Gerald Shucklin, Asst. U. S. Atty. appears for the Government. Attorney Albert Rosellini appears for the defendant. The defendant is present with his counsel. Motion for arrest of judgment and stay of proceedings is called and argued and denied. Motion of Dismissal is denied. Motion for new trial is denied. Sentence is pronounced. Defendant is remanded in custody of the U. S. Marshal. Later: Written judgment and sentence, the terms of which are as orally pronounced by the Court, is signed. Mr. Rosellini gives oral notice of appeal. On recommendation of Government attor-

ney, appeal bond is fixed in sum of $5000.00. The court orders said bond to be a surety bond. [28]

United States District Court
Western District of Washington
Northern Division

UNITED STATES OF AMERICA,
Plaintiff,

vs.

JAMES NATHAN LOWERY,
Defendant.

JUDGMENT AND SENTENCE

Comes now on this 20th day of July, 1942, the said defendant James Nathan Lowery into open court for sentence, with Albert D. Rosellini, his attorney, and said defendant being informed by the Court of the charges herein against him and of his conviction of record herein, he is asked whether he has any legal cause to show why sentence should not be imposed and judgment had against him, and he nothing says, save as he before hath said.

Wherefore, by reason of the law and the premises, the defendant having waived trial by jury and requested that the Court try the cause without jury, and the Court having found the defendant guilty as charged in Count II, it is

Considered, Ordered and Adjudged by the Court that said defendant James Nathan Lowery is guilty

as charged in Count II of the Indictment herein, and that on Count II he be committed to the custody of the Attorney General of the United States or his authorized representative for imprisonment in the United States Public Health Service Hospital, Fort Worth, Texas, or in such other like institution as the Attorney General of the United States or his authorized representative may by law designate, for the period of Twenty-one (21) Months, and further, that said defendant pay a fine to the United States of America in the sum of [29] Five Hundred ($500.00) Dollars and stand committed until said fine is paid.

And the said defendant is hereby remanded into the custody of the United States Marshal for this District for delivery to the Medical Officer in Charge, United States Public Health Service Hospital, Fort Worth, Texas, for the purpose of executing said sentence. This judgment and sentence for all purposes shall take the place of a commitment, and be recognized by the Warden or Keeper of any Federal Penal Institution as such.

Done in Open Court this 20th day of July, 1942.

JOHN C. BOWEN,
United States District Judge.

Presented by:

GERALD SHUCKLIN,
Asst. United States Attorney.

Violation of Section 174, Title 21, U.S.C.A. (Narcotic Drugs Import & Export Act.)

[Endorsed]: Filed July 20, 1942. [30]

[Title of District Court and Cause.]

NOTICE OF APPEAL

Name and address of appellant:
JAMES NATHAN LOWERY
727-28th South
Seattle, Washington

Name and address of appellant's attorney:
ALBERT D. ROSELLINI
1111 Smith Tower
Seattle, Washington

Offense: Violation of the Narcotic Drugs Import and Export Act. (Sec. 174, Title 21, U.S.C.A.)

Date of Judgment: July 20, 1942.

Brief description of judgment or sentence: That the defendant is guilty of the offense charged in Count II of the Indictment and that he be committed and sentenced for imprisonment in the United States Public Health Service Hospital, Fort Worth, Texas, for twenty-one (21) months, and that he pay a fine in the sum of Five Hundred ($500.00) Dollars and stand committed until said fine is paid.

Name of prison where now confined if not on bail: King County Jail.

I, the above-named Appellant, hereby appeal to the United States Circuit Court of Appeals for

the Ninth Circuit from the judgment above-mentioned on the grounds set forth below.

Dated: July 23, 1942.

Copy received July 23, 1942.

JAMES NATHAN LOWERY,
Appellant.
J. CHARLES DENNIS,
U. S. Atty.
By S. RISE. [31]

Grounds of appeal:

1. That the court failed to grant defendant's motion to suppress the evidence and exhibits in this case, which motion was based on the ground that there had been an unlawful search and seizure of the person and property of the defendant.

2. Error of the court in refusing on cross-examination of the government witnesses to allow said witnesses to reveal the name of the informer.

[Endorsed]: Filed Jul. 23, 1942. [32]

[Title of District Court and Cause.]

STATEMENT OF POINTS RAISED ON APPEAL

To: The Clerk of the Above Entitled Court, and to the Attorneys for the Appellee:

You and each of you will please take notice that the Appellant will rely on the following points in his appeal herein:

1. The denial of Appellant's motion to suppress the evidence with reference to the narcotics, on the ground and for the reason that the evidence was obtained by means of an unlawful search and seizure of the person and property of the Appellant.

2. The admission of evidence with respect to the narcotics seized, on the ground that the same were seized by means of an unlawful search and seizure.

3. The denial of the challenge to the sufficiency of the evidence on the ground that all the evidence introduced at the trial was based on an unlawful search and seizure.

ALBERT D. ROSELLINI,
Attorney for Appellant.

Office and Post Office Address: 1111 Smith Tower, Seattle, Washington.

Copy Received, Aug. 31, 1942.
GERALD SHUCKLIN,
Asst. United States Attorney.

[Endorsed]: Filed Aug. 31, 1942. [33]

[Title of District Court and Cause.]

PRAECIPE FOR TRANSCRIPT OF RECORD

To the Clerk of the Above Entitled Court:

You are hereby requested to make a transcript of the record in the above entitled cause and transmit

the same to the United States Circuit Court of Appeals for the Ninth Circuit, and to include in such transcript of record the following:

1. Indictment;
2. Arraignment and plea;
3. Motion to suppress;
4. Affidavit on motion to suppress;
5. Order denying motion to suppress;
6. Court's decision;
7. Motion for new trial; Motion for Dismissal of Action; Motion for Arrest of Judgment and Stay of proceedings;
8. Order denying motion for new trial; Order denying Motion for Dismissal of Action; Order denying Motion for Arrest of Judgment and Stay of Proceedings;
9. Judgment and Sentence;
10. Notice of Appeal;
11. Assignments of Error; [34]
12. Praecipe.

ALBERT D. ROSELLINI,
Attorney for Defendant and Appellant.

Received copy of the within Praecipe this 31 day of August, 1942.

G. D. HILE,
Assistant United States Attorney. Attorney for plaintiff and Appellee.

[Endorsed]: Filed Aug. 31, 1942. [35]

[Title of District Court and Cause.]

GOVERNMENT'S PRAECIPE FOR ADDITIONAL TRANSCRIPT OF THE RECORD

To the Clerk of the Above-Entitled Court:

In addition to the matters requested by the defendant's Praecipe herein, please include in the transcript of the record on appeal the following:

1. Affidavits in opposition to the defendant's Motion to Suppress, namely, that of:
   Donald M. Smith
   Gilbert T. Belland
   Henry L. Giordano
   A. M. Bangs
2. Waiver of Trial by Jury executed by the defendant.
3. Defendant's Oral Notice of Appeal of July 20, 1942, and this Praecipe.

J. CHARLES DENNIS,
United States Attorney.
G. D. HILE,
Assistant U. S. Attorney.
Attorneys for the United States, Plaintiff and Appellee.

Received copy of the within Praecipe this 8th day of September, 1942.

ALBERT D. ROSELLINI,
Attorney for Defendant and Appellant.

[Endorsed]: Filed Sep. 9, 1942. [36]

United States District Court
Western District of Washington
Northern Division

CERTIFICATE OF CLERK TO TRANSCRIPT OF RECORD ON APPEAL

I, Judson W. Shorett, Clerk of the United States District Court for the Western District of Washington, do hereby certify that the foregoing typewritten transcript of record, consisting of pages numbered from 1 to 36, inclusive, is a full, true and complete copy of so much of the record, papers and other proceedings in the above and foregoing entitled cause, as is required by praecipe of counsel filed and shown herein, as the same remain of record and on file in the office of the Clerk of said District Court at Seattle, and that the same constitute the record on appeal herein from the judgment of said United States District Court for the Western District of Washington to the United States Circuit Court of Appeals for the Ninth Circuit.

I further certify that I transmit herewith as part of the record on appeal in this cause the original Bill of Exceptions and Assignments of Error filed in the cause.

I further certify that the following is a true and correct statement of all expenses, costs, fees and charges incurred in my office by or on behalf of the appellant for making record, certificate or re-

turn to the United States Circuit Court of Appeals for the Ninth Circuit, to-wit:

Clerk's fees (Act of Feb. 11, 1925) for making record, certificate or return,

50 folios at 15c	$ 7.50
25 folios at 5c	1.25
Appeal fee	5.00
Certificate of Clerk to Transcript	.50
	$14.25

I hereby certify that the above amount has been paid to me by the attorney for the appellant.

In Witness Whereof I have hereunto set my hand and affixed the official seal of said District Court at Seattle, in said District, this 14th day of September, 1942.

JUDSON W. SHORETT,
Clerk.
By E. M. ROSSER,
Deputy.

[Title of District Court and Cause.]

BILL OF EXCEPTIONS

Be It Remembered that heretofore, to-wit: on the 6th day of July, A. D. 1942, at the hour of 10:00 o'clock a. m. of said day, this cause came on for hearing in the above entitled court before the Honorable John C. Bowen, Judge of said Court, sitting

without a jury, whereupon the following proceedings were had and testimony taken, to-wit:

Appearances:

J. Charles Dennis, United States Attorney, by Gerald Shucklin, Esq., Assistant United States Attorney;

Albert D. Rosellini, Esq., attorney for the defendant.

Whereupon the above-entitled cause came on for hearing on a motion to suppress, which motion was argued by counsel for the plaintiff and by counsel for the defendant, and was by the Court overruled; to which ruling of the Court, by his counsel, the defendant then and there duly excepted. Whereupon the trial of the said cause ensued as follows:

TESTIMONY

DONALD R. SMITH,

being called as a witness on behalf of the plaintiff, having been first duly sworn, testified as follows: (3)

Direct Examination

By Mr. Shucklin:

My name is Donald R. Smith and I reside in Seattle, and am a narcotic agent with the Federal Bureau of Narcotics. I have held that position since last August. I met James Nathan Lowery [1*] the defendant in the course of my duties and I see him in the court room.

Mr. Rosellini: I will object, if the court, please, to any testimony with reference to this search and seizure of the defendant on the ground that it was an unlawful search and seizure.

The Court: Overruled.

Mr. Rosellini: Exception.

The Court: Allowed.

Mr. Rosellini: May we consider that this objection goes to all of this testimony, Your Honor?

The Court: Is that agreeable?

Mr. Shucklin: That is agreeable.

The Court: The Court approves, and it may be so understood.

Narcotic Agent Giordano and myself went to the King County Airport and awaited the plane which was to arrive at 12:10 a. m. on the morning of March 29, 1942. We met Narcotic Agent Hain

*Page numbering appearing at foot of page of original Reporter's Transcript.

(Testimony of Donald R. Smith.)

and Officer Belland of the Seattle Police Department at the airport. At 12:55 the plane arrived and the defendant Lowery landed from the plane. We saw him leave the plane, he looked around in both directions as he got off the plane and he proceeded toward and entered the depot. He waited at the luggage counter, claimed his bag, and proceeded outside to the limousine that the airline operates to take passengers into town. He went to the back of the limousine and handed his bag to the driver. At that time, Agent Hain came up and said, "Federal officers—Take the bag."

Lowery went voluntarily with Giordano, Hain, Belland and myself over to Agent Hain's car, which was a Narcotics Bureau car. There were two cars, a sedan and a coupe which Giordano and myself had driven up there. The other three officers got into Hain's car with Lowery and went to the United States [2] Court House. The bag was in the car with Lowery and the other officers. We all went into the Court House to our offices and met District Supervisor Bangs. The defendant Lowery opened the grip and gave me the narcotics, seven cans of which were in a small shaving kit and three cans of a different shape were wrapped in newspaper, the defendant stating, in the presence of myself, Supervisor Bangs, Agent Hain, Agent Giordano and Officer Belland, that he had obtained these cans on his trip to El Paso and paid $65.00 a tin for them. Plaintiff's Exhibit No. 1 for identification, consisting of seven tins, I saw in the de-

(Testimony of Donald R. Smith.)

fendant's shaving kit and Lowery handed those to me. Plaintiff's Exhibit No. 2 for identification, consisting of three tins, were wrapped in a newspaper and were also in the grip. Lowery handed them to me. The contents of plaintiff's Exhibit No. 3 for identification had leaked out inside the grip, the substance being black, as it appears on the exhibit. I only looked in Exhibit 3 and not in any of the others. Exhibits 1, 2, and 3 were initialed for identification by all the officers except Mr. Bangs, and delivered by myself to the United States Officer, Ringstrom, for safekeeping. The exhibits were in no way disturbed as to contents and when I handed them to Ringstrom their condition was the same as when Lowery handed them to me.

Cross-Examination

By Mr. Rosellini:

I'm twenty-seven years of age, and worked for the Government for two years. Since August I have been in the Narcotics Division as an agent. Prior to that I was Mr. Bang's clerk. The first time I heard of Mr. Lowery was in a report on June 11, 1941, by an officer to his District Supervisor in the California Division, which report had in [3] turn been forwarded to our office. The report stated that Lowery was suspected of traffic in narcotics between California and Montana and gave a description of his personal baggage and license number and a picture of him. So far as I know, we had no previous information on Mr. Lowery. After June, 1941, I received some information about

(Testimony of Donald R. Smith.)

Lowery in the early part of February, 1942, from a man who was working for me, to the effect that Lowery had been using or selling narcotic drugs. This man was a confidential informant and is in Seattle.

Q. And what is his name?

Mr. Shucklin: I object to any testimony in reference to the informer's name, because it is a confidential source of information and against public policy to disclose the information, as it would expose the informer to probable evil consequences.

Mr. Rosellini: Of course, that is just surmise.

(Further argument and citing of cases by counsel.)

The Court: I have had that question before me before and I have, I think, in every case, sustained an objection as to the giving of the name. You may ask him other questions touching the matter and make such other inquiries as will not result in disclosing the name of the informer. The objection is sustained.

Mr. Rosellini: May we have an exception?

The Court: You have an exception, and you may inquire further in other respects as to the basis of probable cause.

This informer has been working for me 8 or 9 months to date. About the time Lowery was apprehended he had worked for me about six months. This informer is usually paid on a reward basis, based on the importance of the case and when [4]

(Testimony of Donald R. Smith.)

it is completed. He was paid $150.00 after the arrest of Lowery. That is the total compensation he received for this case. He had been used by this office on one other investigation. I had never completed before but one case with him. However, I have used him on other investigations. I have never used this informer in any other case where we have secured the conviction of any defendant. I have used him to secure the arrest of Ephriam Blackmann. Blackmann's arrest took place the early part of June, 1942, which was after the Lowery arrest, but the evidence in that case was made in February. I never secured the arrest of anyone prior to the Lowery case on the basis of information furnished me by the same informer. He gave me no information on any other cases as distinguished from investigation, prior to March 29, 1942. I had known this informer six months prior to Lowery's arrest. He is in the same business as the defendant, that is, the gambling business. I do not know if the informer deals in narcotics or whether he has been arrested in connection with narcotics, but he is not an addict; to my knowledge he has not been arrested for violation of any law. The informer did not show me the letter which I set out in my affidavit; but told me the approximate contents of the letter; he did not show me the telegram set forth in my affidavit, but told me of it. Lowery went voluntarily with us in the car after we told him we were federal narcotic agents. I was not

(Testimony of Donald R. Smith.)
armed at that time. I do not believe the other officers were armed. What I mean to say by going voluntarily is that he did not offer any physical or verbal resistance. Witness excused.

HUGO RINGSTROM

was called as a witness on behalf of the plaintiff, having been first duly sworn, and testified as follows: [5]

Direct Examination

By Mr. Shucklin:

I have been a chemist for the Alcohol Tax Unit for 19 years and have done work for the Federal Narcotics Bureau over that entire period. I have a Master's degree in chemistry from the University of Minnesota and have had 19 years' experience in analyzing narcotics and opium. I have had Exhibits 1, 2 and 3 for identification in my possession ever since Narcotic Agents Don Smith and Henry Giordano delivered them to me, and they are in the same condition as when delivered to me except for the quantity taken for analysis. I analyzed the substance in Exhibits 1, 2, and 3 for identification and found it to be smoking opium. The quantity was approximately 50 ounces.

Mr. Shucklin: We offer in evidence at this time Government's Exhibits 1, 2 and 3 for identification.

Mr. Rosellini: If the Court please, we object to

(Testimony of Hugo Ringstrom.)

the introduction of this evidence, or any testimony with respect to this on the ground and for the reason that the same were obtained by means of an unlawful search and seizure, in violation of the defendant's constitutional rights.

The Court: Objection overruled.

(Cans—plaintiff's Exhibits 1, 2 and 3—received in evidence.)

Mr. Rosellini: May we have an exception, if Your Honor please, for the record?

The Court: Exception allowed.

Mr. Rosellini: At this time I would like to move to strike the witness' testimony on the same ground that we based our exception on, Your Honor.

The Court: Motion denied.

Mr. Rosellini: And I would like an exception. [6]

The Court: Exception allowed.

Witness excused.

GILBERT T. BELLAND

was called as a witness on behalf of the plaintiff, having been first duly sworn, and testified as follows:

Direct Examination

By Mr. Shucklin:

My name is Gilbert T. Belland, resident of Seattle, Detective Lieutenant of the Narcotic Squad,

(Testimony of Gilbert T. Belland.)

Seattle Police Department. I have been with the Police Department since 1921 and have been in charge of the Narcotic Squad since July 1, 1934. I went to Boeing Airfield on the evening of March 28, 1942, with Federal Narcotic Agent Hain. I saw the defendant Lowery come off a plane the morning of March 29, 1942. He secured his baggage and went to the airport bus and handed his bag to the driver of the bus and was then taken by the Federal Narcotic Agent Hain and myself to the car that I came down in. Narcotic Agents Giordano and Don Smith were also there. I secured the bag and placed it in the automobile. Lowery sat with me in the back seat and we went up to the Court House, to the Federal Narcotics Office. Hain, Giordano, Lowery and myself were in the car. As we were leaving the airport Hain asked the defendant what he had in the bag. The defendant said, "Well, you know what I've got in the bag. I've got ten cans." When Bangs arrived, he asked the defendant what he had in his bag and Lowery said "I have the ten cans." Then Bangs asked him of what, and then the defendant said "Opium," and the defendant opened the bag. Lowery stated he had purchased the cans from a Mexican in El Paso that he met on the corner and paid $650.00 for them. I may have left the room before Bangs had finished [7] talking to Lowery. Government's Exhibits 1, 2, and 3 all came out of the bag Lowery opened, and were intialed by me.

(Testimony of Gilbert T. Belland.)

Mr. Rosellini: At this time, if the Court please, I move to strike the testimony of this witness with reference to the narcotics, the grip, and the contents of the grip, on the same ground that I heretofore urged, and that is, that the same was obtained through means of an unlawful search and seizure of the defendant, in violation of his constitutional rights.

The Court: Motion denied, and your exception is allowed.

Cross-Examination

By Mr. Rosellini:

It is my duty as head of the Narcotics Division of the Seattle Police Department to keep a record or try to investigate narcotic addicts and narcotic peddlers and secure their arrest if possible. I try to keep a record of people who have a reputation of being in that sort of business either as a peddler or addict. Lowery first came to my attention on or about October 1941 when Agent Martin Hain had a letter which we were assigned to investigate, in which the defendant's name was mentioned as supposedly being engaged in narcotics between the southern part of the United States and Montana. I saw a carbon copy or form of that letter, which I presume is a copy of the letter that Officer Smith testified to. That is the only information that I had about the defendant. Federal Officer Hain and myself attempted to obtain what information we could concerning Lowery. Our investigation did not dis-

(Testimony of Gilbert T. Belland.)

close anything with reference to Lowery trafficking in narcotics, being associated with narcotic agents or having a reputation [8] of being engaged in narcotic traffic. Mr. Bangs explained the case to me regarding the defendant having left Seattle and supposedly would leave El Paso and that he was going to arrive with a quantity of opium around the 25th and 26th of March. After that, for the first time I had my first contact with Agents Smith and Giordano on the case. This is the first specific information I received about the defendant trafficking in narcotics. My investigation did not show whether the defendant was making frequent trips outside of the state. I never talked to the informer prior to Lowery's arrest, and do not know who the informer was. I have reasonable belief as to who the informer was.

> The witness was asked by Mr. Rosellini whether the party that he believed was the informer in the case had a police record. Objection made by Mr. Shucklin was sustained by the Court, and an exception taken to the Court's ruling by Mr. Rosellini was allowed.

We went to the Airport for the purpose of arresting the defendant if he showed up under those circumstances and had that bag. The only information that I had was the information that Mr. Bangs conveyed to me that he had been informed by someone of whose identity I was not sure, plus the letter back in October sent from Los Angeles

(Testimony of Gilbert T. Belland.)

office stating that the defendant was suspected of being in narcotic traffic. I had no personal information as to Lowery trafficking in narcotics or taking this particular trip. I was armed at the time of the arrest. I was about 15 or 20 feet away from Hain when he reached over and grabbed the bag and turned around directly to the defendant. I just surmised that he was placed under arrest and I stepped out alongside of him and kept him back, and Hain was on the other side and we marched him off to the car. He was distinctly told not to reach for his pockets. Witness excused. [9]

HENRY L. GIORDANO

was called as a witness on behalf of the plaintiff, having been first duly sworn, testified as follows:

Direct Examination

By Mr. Shucklin:

I reside in Seattle, and have been with the Narcotic Bureau a little over a year. I went to Boeing Airfield on the evening of March 28, 1942, with Agent Smith, and saw the defendant in the early morning of March 29, 1942. I saw Lowery leave the plane, go to the station, claim his bag and go over to the limousine. As Lowery handed his bag to the driver, Agent Hain stepped up and said "We are Federal officers" and took the bag from the driver and handed it to Officer Belland.

(Testimony of Henry L. Giordano.)

As we were leaving the airport Agent Hain asked Lowery what he had in the bag and Lowery said, "You know what I have," and Hain said, "No, I don't know what you have got," and Lowery answered, "Ten cans." Lowery also said, "You got me now. There is no use asking any questions." At the Court House, Mr. Bangs asked Lowery what he had and Lowery said, "Ten cans." Bangs said, "Of what?" and Lowery answered, "Opium." Lowery opened the bag and took from it a small military case and handed it to Agent Smith and the case was then found to contain seven cans, which are marked as Government's Exhibits 1 and 3, which all contained opium. Lowery also took from the bag a small bundle and it was then found to contain three cans of opium, which is marked as Government's Exhibit 2.

Cross Examination

By Mr. Rosellini:

Prior to being a narcotic agent, I was a pharmacist. I have been a narcotic agent for two years and in the course of my duties—about August 1941—I saw a copy of the [10] letter from the San Francisco office dated June 11, 1941, which stated that Lowery was engaged in narcotic traffic between California and Montana and that he was associating with known narcotic addicts. I made an investigation, which did not disclose that he was trafficking in narcotics between California and Mon-

(Testimony of Henry L. Giordano.)

tana. The only information I had about Lowery was from the letter of June 11, 1941, which information was never substantiated so far as I know. I did find out through the information given to Agent Smith by his informer that Lowery had made two trips to Montana and was contemplating a trip to the southern part of the United States. I never found any evidence of the truth of the suspicion set forth in the letter of June 11, 1941. The next information I had was from Agent Smith about the first of March, 1942, to the effect that Lowery had received a letter from one Tony Alvarado. I did not see the letter but saw only what the informer had copied from it. I was just introduced to the informer and never discussed Lowery with him. I had never used this particular informer, but Agent Smith advised me that he had used him. The only information I had as to the informer's reliability was that given to me by Agent Smith. The only thing Smith told me about this informer was that he was a reliable informer. He did not go into details telling me what kind of a man he was, what his occupation was, or whether he was an addict. About March 26 I received from Mr. Bangs information that the defendant had gone to El Paso. That was three days before the arrest and we made arrangements to meet the plane so that we could find out what he had in his baggage and arrest him if he had narcotics in his baggage. We were not

(Testimony of Henry L. Giordano.)

sure but were fairly certain he had narcotics at that time, but naturally did not want to arrest him unless he had the [11] narcotics. That is why we did not get a warrant for his arrest. We went there with the idea of arresting him if he had narcotics. I was armed.

(Witness excused.)

A. M. BANGS

was called as a witness on behalf of the Plaintiff, and having been first duly sworn, testified as follows:

Direct Examination

By Mr. Shucklin:

I reside in Seattle and have charge of the Fifteenth Narcotic District, which includes Washington, Oregon, Idaho, Montana, and the Territory of Alaska. I saw the defendant Lowery early in the morning of March 29, 1942, at my office in the presence of the other officers as before testified. I asked him to open his suitcase and he did, and he also produced Government's Exhibits 1, 2, and 3. I asked him where he had been and he told me he had been to El Paso and on asking him, he said he had brought back ten cans of opium. We talked about his trip to El Paso and he told me he left Seattle Thursday night, March 26, 1942; that he arrived in El Paso on Friday

(Testimony of A. M. Bangs.)

and remained there until Saturday morning, the 28th; that in El Paso he met a Mexican whom he knows as "Alkatros" who handed him ten cans of opium in an automobile on a street corner in El Paso. He said he paid Alkatros $650.00. I asked him about a certain Mexican and he denied that he had contacted him, saying that he, Lowery, had called the Mexican at Juarez, Mexico, but had been unable to contact him. I told Lowery the best thing for him to do was to get himself a lawyer and he said "What is the use of getting an attorney? You've got me red-handed and all I can do is plead guilty [12] and get it over with." Agent Hain is on detail in Minneapolis and it was not practical to get him here for the trial.

Cross-Examination

By Mr. Rosellini:

The first I heard of the defendant was sometime in June, 1941, when I received a letter from the District Supervisor in San Francisco. That is the same letter that the other witnesses have testified to. The letter was written in Los Angeles, and then submitted to San Francisco, then transmitted to me. The letter advised that Lowery was supposed to be engaged in narcotic traffic between California and Montana, particularly Great Falls. I caused an investigation to be made by the Narcotic office in Montana. By the time of the investigation the defendant had already left.

(Testimony of A. M. Bangs.)

I couldn't say whether he was engaged in narcotic traffic there. The investigation there didn't disclose he had been so engaged. I was never able to prove that any occasional trips that he has taken outside of the state were for the purpose of trafficking in narcotics. I believe that he has been arrested or found to be dealing in narcotics by the Seattle Police Department. I did not know my informant prior to January or February of 1942. I had never used him before, but I knew that Agent Smith had. I met him through Agent Smith, who had authority to receive information from informers. There was no hiring—we take information from anyone who can give it. It is understood that the informer receives pay for his efforts. The informer was used on the Blackmann case, in which the arrest was made after the Lowery arrest. Prior to March, 1942, the informer had never been used in an investigation which resulted in the arrest and conviction of a defendant prior to [13] the Lowery case, but he has been used in investigations and made purchases. I know that the informer is about 40 years of age; I do not know if he has a police record and have made no effort to find out. I relied on the information of the informer in order to secure the arrest of this defendant. I didn't know anything about the informer's activities at that time, except what information he had furnished me and I had been able to verify it as absolutely correct. I was furnished infor-

(Testimony of A. M. Bangs.)

mation about two defendants from this informer prior to March 29, 1942, which defendants have not as yet been arrested. I knew that the information and evidence that I received through the informer about these two defendants that have not been arrested was correct. We do not expect to arrest them for several months. The informer is not a drug addict to my knowledge. We generally check up on informers whenever we can. The Federal officer who sent this informer to me more or less vouched for him.

I saw the excerpts of the letter that was turned over to Agent Smith by the informer and I discussed the same with the informer. The informer did not tell me how he got the information or how he got the letter. I do not know how the letter was addressed or to whom it was addressed. I didn't even see the return address. I knew the informer was reliable and he told me he had seen the letter. He told me that the letter was addressed to the defendant. As I recall, it was this name: "Sonny Lowery." He told me he saw the letter in Room 22 of the Rainier Apartments and I knew from my investigation that Lowery had a room in the Rainier Hotel or Apartment, and that it was 22. I received information on March 26th from the Airline Company about the trip to El Paso by a person answering Lowery's description and I was advised by the United Air Lines after a person answering the defendant's descrip-

(Testimony of A. M. Bangs.)

tion left El Paso, Texas. This person was traveling under the name of James Smith though his bag was initialed J.N.L. [14] As I recall, it was Saturday the 28th. On March 26th, and again on March 28th, I was satisfied that this man was acting for narcotic agents, but I made no attempt to procure a warrant for his arrest or for his search. I instructed my men to go down to the airport and if he returned on either one of the planes that he would return on, to question him or talk to him and find out what he was bringing back with him. I felt I had adequate information in my possession to establish probable cause for taking him into custody when he arrived. Questioning and arrest usually come simultaneously.

(Witness excused.)

Mr. Shucklin moved to dismiss Count I. and elected to proceed on Count II. The motion was granted by the Court and Count I. was ordered dismissed on the Government's Motion.

The Government rests.

The Court: The plaintiff rests. The defendant may now proceed.

Mr. Rosellini: If the Court please, at this time we wish to renew our motion for the suppression of the evidence in this case on the same grounds, of course, that it was obtained through unlawful search and seizure.

I am not going to take any extended time, but I should like to point out one or two facts that the testimony here revealed, on cross-examination and direct examination of the Government's witnesses, which I think substantiates our position that there was no probable cause for the arrest.

In the first place——,

(There was further argument.)

The Court: The motion which has been urged to suppress the evidence is denied, and the challenge to the sufficiency of the evidence is overruled, and the motion to dismiss is [15] likewise denied.

Mr. Rosellini: May I have an exception to the denial of the motions, Your Honor?

The Court: Yes, you may have exceptions to the denial of the motion to suppress the evidence and the overruling of the motion to the challenge of the sufficiency of the evidence.

Mr. Rosellini: The defendant is not going to offer any testimony, Your Honor.

The Court: Does the defendant now rest?

Mr. Rosellini: The defendant rests.

The Court: Is there any further testimony?

Mr. Shucklin: No further testimony, Your Honor.

The Court: Very well.

Mr. Shucklin: I am willing to submit the case, Your Honor.

Mr. Rosellini: I am willing to submit the case also, Your Honor.

(There was a discussion off the record, after which the following occurred.)

Mr. Rosellini: We have nothing further to say, except at the end of the argument of both the Government and the defense, we now renew our motions which we have just made, which the Court has overruled and has allowed exceptions.

The Court: Those motions are denied, and the exception requested is allowed in each instance.

By the Court: (After discussing the facts of the case) For these reasons, I think that the Court must find and decide that, on the proof offered here, the defendant is guilty as charged in Count Two and that is the decision of the Court. [16]

The correctness, completeness and sufficiency of the foregoing Bill of Exceptions are hereby approved.

J. CHARLES DENNIS
United States Attorney
G. D. HILE
Assistant United States Attorney
ALBERT D. ROSELLINI
Counsel for Defendant

[Endorsed]: Filed Sep. 8, 1942. [17]

[Title of District Court and Cause.]

CERTIFICATE

United States of America
State of Washington
County of King—ss.

I, John C. Bowen, Judge of the District Court of the United States for the Western District of Washington, Northern Division, and Judge before whom the foregoing cause entitled: "United States of America, Plaintiff, versus James Nathan Lowery, Defendant", was heard and tried do hereby certify that the matters and proceedings embodied in the foregoing Bill of Exceptions are matters and proceedings occurring in the said cause, and that the same are hereby made a part of the record therein; and I further certify that the said Bill of Exceptions, together with all of the exhibits admitted and on file in said cause, and attached to said Bill of Exceptions, contains all the material facts, matters, and proceedings heretofore occurring in said causes and not already a part of the record therein; and said Bill of Exceptions and the exhibits attached thereto, are hereby made a part of the record in said causes, the Clerk of the Court being hereby instructed to attach all the exhibits thereto.

Counsel for the respective parties being present and concurring herein, I have this day signed this Bill of Exceptions.

In Witness Whereof, I have hereunto set my hand this 8th day of September, 1942.

JOHN C. BOWEN
Judge of the District Court
of the United States.

Copy Received, August 31, 1942.
G. D. HILE
Asst. United States Attorney.

The foregoing is expressly approved by all parties herein.

ALBERT D. ROSELLINI
Atty. for Appellant
G. D. HILE
Atty. for Appellee

[Endorsed]: Filed Sep. 8, 1942.

[Title of District Court and Cause.]

ASSIGNMENTS OF ERROR

Comes Now the appellant, James Nathan Lowery, by his attorney, Albert D. Rosellini, and in conformity to the Court's order that Assignments of Error be served and filed on or before the 31st day of August, 1942, and in connection with appellant's appeal herein, makes the following Assignments of Errors, upon which appellant will

rely in the prosecution of his appeal herein, to-wit:

1. That the Court erred in denying Appellant's motion to suppress the evidence and exhibits in the case, for the reason and upon the ground that there was an unlawful search and seizure of the person and property of the Appellant in violation of his constitutional rights.

2. The Court erred in denying Appellant's challenge to the sufficiency of the evidence at the close of the entire case, and in the refusal of the Court to dismiss Count Two of the Indictment upon the ground and for the reason that all of the evidence in the case was obtained by means of unlawful search and seizure of the person and property of the Appellant.

ALBERT D. ROSELLINI
Attorney for Appellant.

Office and Post Office Address: 1111 Smith Tower, Seattle, Washington.

Copy Received, Aug. 31, 1942.

G. D. HILE
Assistant United States Attorney.

[Endorsed]: Filed Aug. 31, 1942.

[Endorsed]: No. 10211. United States Circuit Court of Appeals for the Ninth Circuit. James Nathan Lowery, Appellant, vs. United States of America, Appellee. Transcript of Record. Upon Appeal from the District Court of the United States for the Western District of Washington, Northern Division.

Filed September 17, 1942.

PAUL P. O'BRIEN,
Clerk of the United States Circuit Court of Appeals for the Ninth Circuit.

No. 10211

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IN THE

UNITED STATES CIRCUIT COURT OF APPEALS

FOR THE NINTH CIRCUIT

JAMES NATHAN LOWERY,
Appellant,

vs.

UNITED STATES OF AMERICA,
Appellee.

APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES FOR THE WESTERN DISTRICT OF WASHINGTON, NORTHERN DIVISION

HONORABLE JOHN C. BOWEN, *Judge*

Appellant's Opening Brief

ALBERT D. ROSELLINI,
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1111 Smith Tower,
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WESTERN PRINTING CO. SEATTLE, WASHINGTON

No. 10211

IN THE

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HONORABLE JOHN C. BOWEN, *Judge*

Appellant's Opening Brief

STATEMENT OF JURISDICTION

The appellant was indicted for violation of the Act of December 17, 1914, as amended, and violation of the Narcotic Drugs Import and Export Act in two counts in the District Court of the United States for the Western District of Washington, Northern Division, on May 27, 1942 (Tr. 2). The charges involved violations of Sec. 2553-A, Internal Revenue Code, and Sec. 174, Title 21, U.S.C.A. On the 6th day of June, 1942, the defendant

entered a plea of not guilty to Count I and Count II of the indictment (Tr. 5). The appellant made a motion supported by affidavits, for suppression of evidence, which was heard on the 6th day of July, 1942. This motion was argued and denied (Tr. 24). The appellant waived a trial by jury (Tr. 23). Count I of the indictment was dismissed on motion of the Government at the end of the Government's case, and the trial resulted in a verdict of Guilty as to Count II. (Tr. 25).

The District Court had jurisdiction (28 U.S.C.A. 41, Jud. Code, Sec. 24, par. I). The Circuit Court of Appeals had jurisdiction (28 U.S.C.A. Sec. 225, Jud. Code, Sec. 128).

STATEMENT OF THE CASE

Appellant was indicted, tried, and convicted in the United States District Court, Western District of Washington, Northern Division, for the crime of possession of narcotics. Count I of the indictment was dismissed upon motion of the Government at the end of the Government's case. The evidence introduced at the trial of this case showed that the appellant got off a United Airlines Plane about one o'clock A. M. on March 29, 1942, at the Boeing Airfield, Seattle, Washington. Appellant took his grip and proceeded to the Boeing Airline cab, which was waiting to drive passengers into town. The appellant turned his bag over to the driver of the cab, at which time a Federal Narcotic Agent, Hain, who was present with Narcotic Agents Smith and Giordano and City Detective Belland, took the bag from the driver, at the same time stating that

they were Federal Officers (Tr. 40). The appellant went to the Federal Courthouse with the officers and en route to the Courthouse, in answer to a question by one of the agents as to how much he had in the bag, appellant answered, "Ten." (Tr. 50). At the Federal Courthouse, the contents of the bag were removed, and they proved to be ten cans of smoking opium.

The record does not disclose that the defendant has ever before been convicted of any crime.

The testimony of the Federal Narcotic Agent Donald Smith showed that he was 27 years of age, and had worked a little less than one year in the narcotic division of the Government. His testimony was that the first information he had of Lowery was in a report on June 11, 1941, by an officer from the California narcotics division, stating that appellant was suspected of traffic in narcotics between California and Montana (Tr. 41). The testimony of Narcotic Agent Giordano and City Detective Belland showed that the only information they had about the appellant was from this same report from the California office of the narcotics division. Both officers testified that they investigated the report but were unable to find that the appellant was trafficking in narcotics or was associated with narcotic peddlers, or had a reputation of being engaged in narcotic traffic (Tr. 48, 50 and 51). Testimony of Narcotic Agent Smith was also to the effect that an informer who had been working for him about six months prior to the time of the arrest of appellant had shown him a copy of a letter indicating that appellant was to arrive on the plane on March 29, on which he did ar-

rive (Tr. 42). Smith's testimony was that the informer was paid $150.00 after the arrest of Lowery, and that he had never secured the arrest of anyone prior to appellant's case on the basis of information furnished him by the same informer (Tr. 43). Smith further testified that he did not know whether the informer was a dealer in narcotics (Tr. 43). Officer Belland testified that as head of the narcotics division of the Seattle Police Department, he keeps a record of narcotic addicts and peddlers; that his investigation failed to disclose any activity of the appellant in narcotic traffic (Tr. 47).

Officer Giordano testified that he never found any evidence of the truth of the suspicion set forth in the letter or report of June 11, 1941, which was the basis of the investigation of appellant (Tr. 41).

Officer Bangs, who has charge of the Fifteenth Narcotic District, testified that the only information that he had about appellant was from the letter which he received in June, 1941; also that the informer used in this case had never been used in an investigation which resulted in the arrest and conviction of a defendant prior to the Lowery case (Tr. 54). Officer Bangs further testified that on March 26th and again on March 28th, he had evidence that appellant was acting for narcotic peddlers, but he made no attempt to procure a warrant for his arrest or for his search (Tr. 56).

Appellant presented a motion to suppress the evidence, which was argued and denied before the trial commenced. Appellant objected to the introduction of any evidence with reference to the narcotics, contend-

ing the same were obtained by means of unlawful search and seizure. At the end of the Government's case, appellant moved for a dismissal of the case on the ground and for the reason that the evidence upon which the case was based had been obtained through unlawful search and seizure in violation of the 4th and 5th Amendments of the Constitution of the United States. The motions were denied and the appellant found guilty on Count II (Tr. 25). Appellants presented motions for new trial, for dismissal of the action, and for arrest of judgment and stay of proceedings, all of which were argued and denied on July 20, 1942 (Tr. 28). Judgment and sentence were pronounced, finding the appellant guilty, and sentencing him for the period of twenty-one months in the United States Public Health Service Hospital at Fort Worth, Texas, and sentencing him to pay a fine in the sum of $500.00 (Tr. 30).

ASSIGNMENT OF ERRORS

Appellant is relying upon the following assigned errors:

1. That the Court erred in denying Appellant's motion to suppress the evidence and exhibits in the case, for the reason and upon the ground that there was an unlawful search and seizure of the person and property of the Appellant in violation of his constitutional rights.

2. The Court erred in denying Appellant's challenge to the sufficiency of the evidence at the close of the entire case, and in the refusal of the Court to dis-

miss Count Two of the Indictment upon the ground and for the reason that all of the evidence in the case was obtained by means of unlawful search and seizure of the person and property of the Appellant.

ARGUMENT

As both assignments of error relate and are based upon an unlawful search and seizure of the person and property of the appellant, in violation of his constitutional rights, the same will be treated jointly in presenting this argument. Appellant contends that the search and seizure of himself and his personal belongings and his arrest were unlawful, and in violation of the 4th and 5th Amendments to the Constitution of the United States.

Even at common law, the right of the people to be secure in their persons, houses, and effects against unreasonable search and seizure was recognized. This common law right of course was enacted into the Constitution of the United States when the Fourth Amendment was adopted. The rule has been adopted and followed that a warrant of some kind is necessary in order to effect this search and seizure of a person, his property and effects. An exception to that rule has always been that where officers have probable cause to believe that an offense is being committed, they have a right to search and seize without a warrant.

In *Cardinal v. United States*, 79 Fed. (2) 825, it was held that entry and search without a warrant was illegal, unless officers had probable cause to believe that an offense was being committed.

In *United States v. Batune,* 292 Fed. 497, it was held that to justify a government agent in making an arrest and search and seizure without a warrant, he must have such knowledge from the employment of his own senses or from information actually imparted to him by another as to cause him honestly and in good faith, acting with reasonable discretion, to entertain the belief or suspicion that the law is being violated.

Belief alone, however well founded, that an article is concealed in a dwelling has been held to be no justification for search without a warrant notwithstanding that the facts unquestionably showed probable cause in the case of *United States v. Baldocci,* 42 Fed. (2) 567. Probable cause has been held to mean reasonable ground of suspicion supported by circumstances sufficiently strong in themselves to warrant a cautious man in believing that the person is guilty of the offense charged. *United States v. Hayes,* 52 Fed. (2) 977.

The rule is that there should be a liberal construction in favor of the defendant of the Fourth Amendment in legislation regulating search warrants, and it has been held that the guarantees of the Fourth Amendment must be liberally construed to prevent impairment of the protection extended by such amendment.

Go-Bart Importing Co. v. United States, 282 U. S. 344;

Grau v. United States, 287 U. S. 124.

In *Gouled v. United States,* 255 U. S. 298, it was held that the provisions of the fourth amendment protecting against unreasonable seizure and search are indispensable to the full enjoyment of personal security,

liberty and private property and should receive a liberal construction to prevent an encroachment on the rights secured by them.

The case of *United States v. Tom Yu,* 1 Fed. Supp. 357, involved the same charges as is set forth in Count II of the Indictment in the instant case, and is somewhat analogous to our present situation. The facts there disclose that a narcotics agent received information to the effect that smoking opium was being shipped to a designated address and was being there distributed. The narcotics agent had no personal knowledge of any of the facts, but acting upon the hearsay information received, he, together with another agent and a deputy sheriff, went to the defendant's residence. The officers claimed that on approaching the building they smelled the fumes of smoking opium and after returning a second time and again smelling the fumes of smoking opium, broke in the door and arrested the defendant and searched the premises, finding therein a quantity of opium. The Court, in granting a motion to suppress, stated as follows:

> "The important question to determine is whether the information conveyed to the officers and the fact that they smelled the fumes of smoking opium was sufficient to justify an honest belief that a crime was being committed in their presence. The search of the defendant's dwelling without a warrant was unlawful unless it can be said that a crime was being committed in his presence." (P. 359). * * * *
>
> "In the case of *Byars v. U. S.,* 273 U. S. 32, 47 S. Ct. 248, 249, 71 L. Ed. 520, it is said: 'Con-

stitutional provisions for the security of person and property are to be liberally construed, and 'it is the duty of courts to be watchful for the constitutional rights of the citizen, and against any stealthy encroachments thereon.' *Boyd v. U. S.,* 116 U. S. 616, 635, 6 S. Ct. 524, 535, 29 L. Ed. 746.' '' See, also, *Gouled v. U. S.,* 255 U. S. at p. 305, 51 S. Ct. 261, 65 L. Ed. 647.

''Regardless of how desirable or necessary it may be to suppress the traffic in narcotic drugs, yet well-founded principles of law cannot be ignored, nor constitutional guaranties disregarded to accomplish the purpose.'' (P. 360.) * * *

Although the above case dealt with search of a residence the same general principles involved apply to the search of a person.

The case of *United States v. Schultz,* 3 Fed. Supp. 273, shows that the officers had received information of the illicit use of the premises involved. After approaching the premises they detected some odors. The Court held that unless such information was based upon personal observation or perceptions, such information was purely hearsay and did not authorize search without a warrant. In that case the Court cites *Gorski v. United States,* 1 Fed. (2) 620, to the effect that an arrest may not be made on mere suspicion. The case of *Hague v. Committee on Industrial Organization,* 101 Fed. (2) 774, held that to justify a search and seizure without a warrant the officers must have direct personal knowledge through their hearing, sight, or other sense, of the commission of a crime by the accused.

The case of *United States v. Banks,* 24 Fed. (2) 973, shows that the narcotic agents had information that the accused was in possession of some narcotics. They went to the accused's apartment, knocked on the door and stated they were Federal narcotic agents. By virtue of their declaration of being officers, the accused opened the door and let them in. The accused was disrobed and they discovered by an examination of his arm that he was a drug addict and they thereupon searched the apartment and found a quantity of heroin. The Court held that the agents had no probable cause and having entered without a search warrant the search and seizure was illegal. The Court also held that consent to the search was not freely given by the fact that the accused opened the door stating that the accused had no alternative when the officers made their identity known, and asked admittance, even though he put up no resistance. In the instant case, the situation was the same, as Lowery put up no resistance when the agents identified themselves, feeling, of course, that he was under arrest, as did the accused in the *Banks* case.

In the case of *Carroll v. United States,* 267 U. S. 132, it was held that the search and seizure was lawful. However, the facts shown were much stronger than in the present case, as two and one-half months before the arrest, the Federal agents had actually agreed to buy whiskey from the defendant, under guise. They had actually talked to the defendant, and he had agreed to sell whiskey to them. At the time of the arrest the defendant was driving the same car that he had two and one-half months before, and the agents stopped him and arrested him, and seized the contents of the car. In

that case there was, of coure, direct contact and direct agreement for the sale of whiskey with the defendant himself. However, even then, Justice Reynolds delivered a vigorous dissenting opinion contending there was not probable cause for the arrest.

In the case of *Ganci v. United States,* 287 Fed. 60, the Court held there was an unreasonable search, and no probable cause to base a search on. In that case, one Smith, a peddler of narcotics and an informer, was given money by the narcotics agents to buy narcotics from defendant Lusco. Smith went with Lusco and waited outside an apartment house for him. Lusco brought out a package of narcotics and the agents being present seized him. Smith when he had been negotiating with Lusco had told the officers that he had seen defendant Ganci present. The agents after the arrest of Lusco went to the apartment house and in searching the house came across a barber shop owned by the defendant Ganci, and searched the same and found narcotics and thereupon arrested Ganci. The Court held that there was no probable cause to justify the search of Ganci's barber shop and that the search was unreasonable and therefor unlawful.

At p. 661, the Court used the following language:

> "We must not be tempted to avoid the preservation of constitutional safeguards because of the nature of the crime charged nor because of difficulties in detecting crime. We realize the insidious and dangerous character of the narcotics concerned in this case and appreciate the skill necessary to discover the traffickers. The Supreme Court, however, has never permitted the obnoxious

> nature of a crime nor the difficulties of detection to dim its view as to the necessity of preserving, at any cost, our hard-won constitutional safeguards, and it may be tritely observed that a stern adherence to that preservation makes both for liberty and order in the long run."

The case of *United States v. Robstein,* 41 Fed. (2) 227, holds that a forcible entry into a locked room in a bottling plant and the searching thereof without a warrant on detecting an odor of alcohol emanating therefrom was illegal.

In the case of *Emit v. United States,* 15 Fed. (2) 623, defendant's car was searched without a warrant. The officers had some information about the defendant's activities and the car of the defendant had been seen parked at a place supposedly used by cars hauling liquor, and it came from a place having a reputation as a haven for bootleggers. The Court held that the search was unlawful as it was based on mere suspicion and not on probable cause.

In the case of *Pales v. Poali,* 5 Fed. (2) 280, the agent had information that the car that was hauling the illegal articles was to travel over a certain road at a certain time with a description of the car and driver. The agent shot at the car and the Court in a case where the agent was on trial and was trying to justify his actions, held that the facts did not justify his actions, that the same were unreasonable, and that he had no probable cause for his actions.

It is submitted that all of the cases which have held the search and seizure sufficient and reasonable have

had much more evidence than in the instant case. In the case of *United States v. Rogers*, 53 Fed. (2) 874, the facts showed that a great volume of illicit beer traffic was carried on on the highway where the defendant was stopped. Also, the truck the defendant was driving had been seen at a "beer drop" and had been seen driven to an apparent saloon. The case of *Carroll v. United States, supra,* as set forth, had many more facts.

In the instant case, there was nothing in the appearance of appellant, nor in the fact that he came off the plane with a grip and gave the same to the airline cab driver which would give rise to any belief that he was committing a crime. His actions were entirely consistent with a legitimate use of the grip, and do not warrant a reasonable belief that he was committing any crime. The fact that the officers claim they had information from an informer in itself is not sufficient. If it were, anyone carrying a suitcase could be stopped and be subjected to search merely because someone had informed the officers that he or she was breaking the law.

It is respectfully submitted that the above cases bear out that hearsay information by a federal agent, not based upon any personal knowledge or any other circumstances, or anything about the appearance of the appellant is not sufficient to authorize a search without a warrant. There is no evidence that Lowery was engaged in any regular narcotic traffic, or that he was engaged regularly in transporting narcotics by plane, or in any other manner. The officers all testified that

their original information about Lowery trafficking in narcotics was not borne out after investigation. Officer Belland testified that Lowery was not known as a narcotic addict or narcotic trafficker. The only information here was the hearsay information given to one of the officers by the informer.

The narcotic agents testified that they had full information of Lowery's activities as early as March 24th, and that on March 28th, they had full information that he was to arrive in Seattle on the morning of March 29th. In view of this information, if they had probable cause at that time, they had ample time to obtain a warrant authorizing them to search and arrest the defendant. Had they had probable cause at that time they would have undoubtedly done so. It is not the province of the law to allow the agents to confirm their beliefs or suspicions by a search and then subsequently obtain an indictment on that illegal search. If they have sufficient information to constitute probable cause for an arrest, and if they have time for the same, such as in this case, the agents should obtain the necessary warrant.

CONCLUSION

We respectfully submit that in view of the above decisions and the evidence in this case, there was an arrest without a warrant, a crime was not being committed in the presence of the officers, and there was no probable cause to justify an arrest of the defendant without a warrant.

We respectfully submit that the motion to suppress the evidence in this cause should have been granted, and the case dismissed.

We respectfully submit that the judgment of the District Court should be reversed, and the above cause be dismissed.

Respectfully submitted,

ALBERT D. ROSELLINI,

Attorney for Appellant.

No. 10211

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

JAMES NATHAN LOWERY,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

UPON APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES FOR THE WESTERN DISTRICT OF WASHINGTON NORTHERN DIVISION

HONORABLE JOHN C. BOWEN, *Judge*

BRIEF OF APPELLEE

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United States Attorney.

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UPON APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES FOR THE WESTERN DISTRICT OF WASHINGTON NORTHERN DIVISION

HONORABLE JOHN C. BOWEN, *Judge*

BRIEF OF APPELLEE

STATEMENT OF THE CASE

This appeal involves the validity of the conviction of appellant on Count II of the Indictment (Tr. 3, 4) charging appellant with receiving, concealing, buying, selling and facilitating the transporta-

tion and concealment after importation of fifty ounces of smoking opium in violation of Title 21, U.S.C.A., Sec. 174.

Appellant's sole contention under his Assignments of Error (Tr. 60, 61) is that the evidence was obtained by unlawful search and seizure in violation of the Fourth and Fifth Constitutional Amendments. We confine our discussion to that contention.

Prior to the trial appellant sought to suppress the evidence which consisted of tins of smoking opium (Tr. 40, 44) by filing a Motion to Suppress. Accompanying the motion were two affidavits, one being that of appellant's attorney of record, and the other of appellant himself (Tr. 5-9). Nowhere do such affidavits or the motion make any claim that appellant was the owner of or claimed any interest in the opium seized, nor that appellant had the possession of the narcotics at the time of the search and seizure.

In opposition to appellant's Motion to Supress, the Government filed four affidavits (Tr. 9-23). To these appellant filed no counter-affidavits or statement. The Government's affidavits disclose that prior to the apprehension of appellant in the early morning of March 29, 1942, the Seattle Narcotics Bureau and

its officers had the following information in their possession:

1. That by virtue of a letter, dated June 11, 1941, received by the Seattle Narcotic Office from the California Office, appellant was believed to be engaged in narcotic activities between California and Montana as of that date (Tr. 10, 14, 20).

2. The Seattle Office, by virtue of an investigation made, ascertained that appellant had left Montana and had come to Seattle about August, 1941, and that appellant was making occasional trips away from Seattle possibly to procure narcotics (Tr. 14). Appellant was known to be residing in Seattle from August, 1941 to July, 1942 (Tr. 10-20).

3. About January or February, 1942, the Seattle Narcotics Office learned that one of their reliable confidential informants was in a probable position to advise when appellant would leave Seattle for the purpose of bringing back smoking opium (Tr. 14).

4. Thereafter in early March, 1942, this informant advised Narcotic Agent Donald R. Smith that appellant had received a letter from one Tony Alvarado of Jaurez, Mexico, which letter stated in effect:

"How are you?

"I got your letter today. My wife went to get it. Don't come until you get tela. with price and

everything. Price no trouble, I want to keep friendship."

Signed "Tony"

In conjunction with this letter the informant disclosed that appellant was going to make a trip south to obtain opium and that he would probably go by airplane (Tr. 10, 14, 15).

5. About March 22, 1942, this informant again advised the Seattle Office that appellant had received a telegram from Tony Alvarado of Jaurez, Mexico, which read as follows:

"I have ten carates good quality answer if you will come.

Tony" (Tr. 10, 11, 14)

Agent Smith checked the Spanish definition of the word "carates" and found it meant "liver spots" or "brown spots" and deduced that the word meant opium (Tr. 11).

6. On March 26, 1942, the officers were advised by the United Airlines at Seattle that a colored male generally answering appellant's description had booked passage by plane for El Paso, Texas, and further, that on the evening of March 26, 1942, a colored male had taken the 8:45 p. m. plane from Seattle, traveling on a round trip ticket, to El Paso; that he was traveling under the name of James Smith, but

that his baggage bore the initials "J.N.L.", the initials of the appellant (Tr. 11. 15).

El Paso, Texas, is just across the border from Jaurez, Mexico, from which the letter and telegram emanated (Tr. 11).

7. On March 28, 1942, the United Airlines at Seattle advised the officers that the said James Smith was booked to return to Seattle by plane and would probably arrive sometime between 8:00 P. M. on March 28, 1942 and 12:10 A. M. on March 29, 1942 (Tr. 11, 15).

8. The officers covered the arrival of both planes and the plane scheduled to arrive at Seattle at 12:10 A. M., March 29, 1942, actually arrived at 12:55 A. M. Appellant Lowery, who was known to one of the agents who recognized him, disembarked from the plane (Tr. 11, 18, 22). The officers, all of whom were in possession of the foregoing information, observed that after appellant left the plane he claimed his bag and proceeded to an automobile furnished by the United Airlines to its passengers. Before the appellant could enter the automobile he was intercepted by the officers who informed him that they were Federal officers and took possession of appellant's bag. The officers had no search warrant. The officers then escorted Lowery to the Federal Narcotic Office in Se-

attle by car. In this car when appellant was asked what he had in the bag, he replied in substance that the officers knew what he had in the bag, that he had ten cans (Tr. 18, 22). At the Seattle Narcotic Office appellant was asked by Supervisor Bangs what he had in the bag, to which appellant replied that he had ten cans of opium. Appellant then opened the bag producing the ten cans, further stating that he had obtained the opium at El Paso for $650 (Tr. 12, 16, 17, 18, 19, 22, 23).

On this state of the record the court on July 6, 1942, denied appellant's Motion to Suppress the evidence (Tr. 24).

The trial proceeded on the same date before the court sitting without a jury pursuant to appellant's request and waiver of trial by jury (Tr. 23, 24).

The only details of any moment here which were developed in addition to the facts stated above were that most of the contents of one of the tin cans had leaked out (Tr. 41); that the total smoking opium contained in the cans was about fifty ounces (Tr. 44); that the confidential informant in the case had theretofore been found reliable and had performed services for the Seattle Narcotic Office for about six months prior to appellant's apprehension (Tr. 42, 54, 55).

Government's Exhibit 1, 2 and 3 which were introduced at the trial were the ten cans of opium above referred to as being in appellant's bag (Tr. 40, 41, 46).

Appellant offered no evidence at the trial and was found guilty by the court on Count II of the Indictment (Tr. 25, 58) and was sentenced to 21 months in the United States Public Health Service Hospital, Fort Worth, Texas, and to pay a fine in the sum of $500, commitment until paid (Tr. 30).

QUESTION

The only question presented is whether or not the search and seizure involved was lawful without a search warrant.

ARGUMENT

Appellant is not entitled to invoke the protection of the Fourth and Fifth Amendments

Appellant, in his Motion to Suppress and his supporting affidavits, makes no claim to ownership or to any interest in the narcotics seized. As a matter of fact, appellant seems to deny that he even had posses-

sion of the narcotics because he makes the following allegations:

> "Affiant was not committing any crime in the presence of said agents" (Tr. 8)

and

> "That the defendant James Nathan Lowery was not committing any crime in their presence" (Tr. 6)

which would seem equivalent to a flat statement that appellant was not the owner, nor had any interest in, nor had intentional possession of the opium.

It is well established that one who seeks to question the legality of a search and seizure under the Amendments must be the owner of the property or have an interest therein and affirmatively claim his ownership or interest in his application for suppression. Mere physical custody is insufficient to entitle one to object that the search and seizure was unreasonable or that his constitutional rights were invaded.

Lewis v. United States (CCA 9), 6 F. (2d) 222;

Armstrong v. United States (CCA 9), 16 F. (2d) 62 (certiorari denied 273 U.S. 766);

Patterson v. United States (CCA 9), 31 F. (2d) 737;

Kwong How v. United States (CCA 9), 71 F. (2d) 71.

As appellant offered no evidence at the trial

(Tr. 55) no contention can be made that appellant made any claim of ownership to, or interest in, the opium seized subsequent to the hearing on the Motion to Suppress.

The Search and Seizure was lawful

The question is whether or not the facts and circumstances which came to the attention of the officers in the instant case prior to appellant's apprehension were sufficient to lead a reasonably discreet and prudent man to believe that appellant was unlawfully in possession of narcotics.

Carroll v. United States, 267 U.S. 132;

Husty v. United States, 282 U.S. 694.

It is exceedingly plain that under the facts of the case that the search and seizure was lawful even though without a search warrant.

Carroll v. United States, supra.

Husty v. United States, supra;

King v. United States (CCA 9), 1 F. (2d) 931;

Foster v. United States (CCA 9), 11 F. (2d) 100;

White v. United States (CCA 9), 16 F. (2d) 870;

McInes v. United States (CCA 9), 62 F. (2d) 180;

Leong Chong Wing v. United States (CCA 9), 95 F. (2d) 903;

Kwong How v. United States (CCA 9), 71 F. (2d) 71;

Mattus v. United States (CCA 9), 11 F. (2d) 503.

Appellant seems to argue that because the information given to the officers was "hearsay" that they could not act upon it. Such a contention cannot be sustained because in practically all of the cases above cited, the information of the officers was based on hearsay. As said in the *Husty* case, *supra*, at pp. 700-701:

> "To show probable cause it is not necessary that the arresting officer should have had before him legal evidence of the suspected illegal act."

In the *Carroll* and *Husty* cases the information of the officers was based on hearsay.

Appellant likewise contends (Tr. 14) that the officers had ample time in which to obtain a search warrant and that therefore the search and seizure was unlawful. The answer to this contention is two-fold:

First: The Fourth Amendment does not denounce all searches or seizures, but only such as are unreasonable.

Carroll v. United States, supra, at p. 147.

Secondly: In the instant case the officers were not sure from their information that the "James Smith" reported to be traveling by plane was the appellant James Nathan Lowery. It was the fact of *appellant* being on the return plane which crystallized all prior information in the possession of the officers and gave the officers the right to act. The officers could not know positively that it was in fact appellant who was on the plane until he was observed disembarking. On these facts the officers were not required to speculate on the chances of later carrying out the search and seizure after the delay which would then have been required for one or more of them to obtain a search warrant.

Husty v. United States, supra, at p. 701

This would seem to be particularly true in this case where appellant was merely in the process of transferring himself and his bag from one vehicle to another and renders inappropriate the cases cited by appellant which relate to searches and seizures of structures or dwellings.

In our opinion a discussion of appellant's authorities is unnecessary because he has not cited a single case from this Circuit, nor has appellant, in our view, cited any case which is in point. Many of his

cases are contrary to his own position and are in favor of the Government's position. In the main, they relate to searches and seizures of dwellings rather than of the person or mobile units.

CONCLUSION

The lower court committed no error in denying appellant's motion to suppress and in overruling all of appellant's objections to the evidence which were based thereon.

The judgment should be affirmed.

Respectfully submitted,

J. CHARLES DENNIS,
United States Attorney.

G. D. HILE,
Assistant United States Attorney.

Attorneys for Appellee.

No. 10211

IN THE

UNITED STATES CIRCUIT COURT OF APPEALS

FOR THE NINTH CIRCUIT

JAMES NATHAN LOWERY,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES FOR THE WESTERN DISTRICT OF WASHINGTON, NORTHERN DIVISION

HONORABLE JOHN C. BOWEN, *Judge*

APPELLANT'S REPLY BRIEF

ALBERT D. ROSELLINI,
Attorney for Appellant.

1111 Smith Tower,
Seattle, Washington.

WESTERN PRINTING CO. SEATTLE, WASHINGTON

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ALBERT D. ROSELLINI,
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CASES CITED

No. 10211

IN THE

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APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES FOR THE WESTERN DISTRICT OF WASHINGTON, NORTHERN DIVISION

HONORABLE JOHN C. BOWEN, *Judge*

APPELLANT'S REPLY BRIEF

Appellee's position that appellant is not entitled to invoke the protection of the Fourth and Fifth Amendments is not sound. Appellee contends that appellant makes no claim to ownership, or to any interest in the narcotics seized. However, an examination of the records shows that appellant at no time disclaimed

interest, possession, or ownership of the narcotics, but to the contrary, always referred to the grip and the contents, which were the narcotics in question, as being his.

In his affidavit in support of his motion to suppress the evidence, appellant states that he took "his grip" (Tr. 7); that the officers took "his grip" and opened "his grip" (Tr. 8). Also, in his affidavit he states that he told the officers that he had "Ten," in referring to the narcotics in "his grip" (Tr. 8).

In the affidavit of Donald R. Smith, the narcotic agent, affiant states that the appellant admitted to him that he had obtained the opium in El Paso, Texas, for $650.00 (Tr. 12), indicating ownership in the appellant. In the affidavit of A. M. Bangs, narcotics supervisor, affiant states that appellant admitted that he had brought back with him "Ten cans" of "opium"; further, that appellant opened his bag and produced therefrom the narcotics (Tr. 16). Affiant further alleged that appellant told him that he had obtained the narcotics in El Paso, Texas, for $650.00 (Tr. 17).

The authorities cited by appellee are not in point. In *Patterson v. U. S.* (C.C.A. 9) 31 F. (2) 737, the defendant openly disclaimed ownership, and denied that the suitcase and the contents were his.

In the case of *Lewis v. U. S.*, (C.C.A. 9) 6 F. (2)

222, a search warrant was used in searching the premises. The Court held that one who claimed no interest in the property seized cannot question the validity of the search warrant.

The case of *Armstrong v. U. S.* (C.C.A. 9) 16 F. (2) 62, is to the same effect, the defendant disclaiming any interest in the property seized.

The case of *Kwong How v. U. S.,* (C.C.A. 9) 71 F. (2) 71, involved the search of the premises and the person of the defendant. The defendant in that case did not reside in the premises searched and disclaimed any interest in the property seized. The Court held that one who is not the owner or the lawful occupant of the premises searched without a warrant cannot raise the question of the lawfulness of the search.

THE SEARCH AND SEIZURE WAS UNLAWFUL

The cases cited by appellee are not helpful. In the case of *Carroll v. U. S.,* 267 U. S. 132, as pointed out in appellant's opening brief, p. 10, the facts were much stronger than in the present case.

In the case of *Husty v. U. S.,* 282 U. S. 694, cited in appellee's brief, it was held that the search and seizure were proper. However, the facts there were much

stronger than in the instant case. The prohibition officer who made the arrest testified that he had known the defendant to be a "bootlegger" for several years, had arrested him twice before for the same offense, had received a phone call that the defendant had two loads of liquor in two automobiles of particular makes and descriptions parked in particular places on certain streets. Also, the officer testified that he was well acquainted with his informant, having known him about eight years, and having had frequent contact with him both in a business and social way. He had received similar information from the informant which had always proved to be reliable. In that case, when the officers were seen by the defendant, two of his companions fled, and the officers made the search and seizure. Under these facts, there was probable cause for the search.

In the case of *King v. U. S.* (C.C.A. 9) 1 Fed. (2) 931, all of the facts are not shown, but the Court states that the officers had reliable and positive information that the defendant was engaged in transporting opium; also that the officers saw the defendant go by and return with all the curtains in his car drawn down. The Court held the search and seizure proper.

The case of *Foster v. U. S.* (C.C.A. 9) 11 F. (2) 100, is not helpful, as the facts upon which the search was based do not appear from the opinion.

The search and seizure in the case of *White v. U. S.,* (C.C.A. 9) 16 F. (2) 870, cited by appellee, was based on strong evidence. One of the inspectors, who mingled with a crowd of narcotic addicts at a certain rooming house, heard them talking about the defendant, and heard them say that the defendant sold narcotics, and that he gave a cube for $1.50. Other officers testified that just prior to the arrest, they saw the defendant walking in the direction of the rooming house, having his overcoat on with the collar pulled up, both hands in his pockets, walking fast, turning around and looking from side to side. The Court held that those facts were sufficient to justify the arrest.

In the case of *McInes v. U. S.,* (C.C.A. 9) 62 F. (2) 180, the officer received a call between midnight and one o'clock A.M. from an informer, whom he knew well, and who had furnished him previously with reliable information, that a Ford coupe with a certain license number, would go from California into Oregon early that morning, loaded with liquor. The officer saw the described Ford, with the described license number, seized the same, and found the liquor. The Court held that those facts justified the arrest without a warrant.

In the case of *Leong Chong Wing v. U. S.* (C.C.A. 9) 95 F. (2) 903, there were much stronger facts. The record therein discloses that the defendant had at a prior date been convicted of violation of the Narcotic

Act; that he was an associate of known narcotic dealers; that enforcement officers had numerous complaints of appellant's activities engaging in the illicit sale of narcotics; that the officers had information from an informant, who had been found reliable on several occasions, to the effect that appellant was about to meet a white man at a specified place for the purpose of making the sale and delivery of narcotics. On three occasions within a period of fifteen days, the officers, acting upon such information, observed appellant, while driving a car, meet the identical white man, who entered appellant's car. On the last of such occasions, the officials, having again received information from the same source, to the effect that appellant would meet a white man in appellant's car, made the arrest.

In the case of *Kwong How v. U. S.,* (C.C.A. 9), 71 F. (2) 71, the officers saw the Chinese defendant come out of a panel door of a room connected by means of a secret passage with the premises in which narcotics had been repeatedly purchased. They saw the defendant carry a satchel partially open, containing small boxes which appeared to the officers to be narcotics. The Court held that the facts justified the arrest.

In the case of *Mattus v. U. S.* (C.C.A. 9) 11 F. (2) 503, the officers sent a thoroughly searched informer into the defendant's house with marked money, to buy

narcotics, and on his return with morphine, they entered the house, arrested the defendant, and seized the morphine which the defendant's wife was trying to conceal. The defendant voluntarily admitted that he did give the morphine to the informer. The Court held that the search was proper.

In each of the cases mentioned above, cited in appellee's brief, there was before the Court a great deal more evidence than in the instant case. In each case where there was hearsay information from an informer, there was always something else to substantiate it. In the instant case, the Government has produced nothing except information furnished to the officers by an informer who had never before completed a case for the officers, and whose testimony had never been used to secure a conviction by the officers. Although the officers testify that the informer was reliable, there is nothing in the record to indicate this. They had known him for only a period of about six months, didn't know whether he had a criminal record, whether he was a narcotic addict, or anything about him. On the limited knowledge that the officers had of the informer, it cannot be said that they were justified in relying upon his information.

For the reasons set forth in appellant's opening brief, and based upon the authorities therein cited, it

is respectfully submitted that there was not probable cause for the search and seizure and the following arrest in this case.

CONCLUSION

We respectfully submit that the appellant was arrested without a warrant, a crime was not being committed in the presence of the officers, and that there was no probable cause to justify the arrest of the defendant without a warrant.

We respectfully submit that the judgment of the District Court should be reversed, and the above cause be dismissed.

Respectfully submitted,

ALBERT D. ROSELLINI,

Attorney for Appellant.

No. 10213

15

United States
Circuit Court of Appeals
For the Ninth Circuit.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION, as Executor of the Last Will and Testament of Elisha Cobb Mayo, deceased,
Respondent.

Transcript of the Record

Upon Petition to Review a Decision of the United States Board of Tax Appeals

ROTARY COLORPRINT, 590 FOLSOM ST., SAN FRANCISCO 9-4-42-60

No. 10213

United States
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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

APPEARANCES:

For Taxpayer:
EDWARD HALE JULIEN.

For Comm'r.:
ARTHUR L. MURRAY, Esq.

Docket No. 102469

BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION as Executor of the Last Will and Testament of Elisha Cobb Mayo, Dec'd.,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DOCKET ENTRIES

1940

May 6—Petition received and filed. Taxpayer notified. (Fee paid).

May 7—Copy of petition served on General Counsel.

June 17—Answer filed by General Counsel.

June 17—Request for hearing in San Francisco, California, filed by General Counsel.

June 27—Notice issued placing proceeding on San Francisco, California, Calendar. Answer and request served.

1941

Apr. 8—Hearing set June 16, 1941 in San Francisco, California.

June 16—Hearing had before Mr. Kern on the merits. Submitted. Stipulation of facts filed. Briefs due July 31, 1941. Reply briefs due Aug. 30, 1941.

July 2—Transcript of hearing 6/16/41 filed.

July 26—Brief filed by taxpayer.

July 31—Brief filed by General Counsel.

July 31—Copy of brief served on General Counsel.

Aug. 23—Reply brief filed by taxpayer. 3/25/41 copy served on General Counsel.

Nov. 17—Memorandum findings of fact and opinion rendered, Kern, Div. 16. Decision will be entered under Rule 50. 11/18/41 copy served.

Dec. 10—Computation of deficiency filed by General Counsel.

Dec. 15—Hearing set Jan. 14, 1942 on settlement.

Dec. 27—Consent to settlement filed by taxpayer.

Dec. 30—Decision entered, Kern, Div. 16.

1942

Mar. 14—Petition for review by United States Circuit Court of Appeals, Ninth Circuit, with assignments of error filed by General Counsel.

Mar. 25—Proof of service filed by General Counsel. (2) [1*]

*Page numbering appearing at top of page of original certified Transcript of Record.

1942

Apr. 16—Certified copy of order from 9th Circuit, granting an extension to 6/22/42 to complete the record filed.

June 10—Certified copy of an order from the 9th Circuit extending the time to August 21, 1942 to transmit the record, filed.

July 28—Statement of points filed by General Counsel—with proof of service thereon.

July 28—Agreed designation of contents of record filed. [2]

United States Board of Tax Appeals

Docket No. 102469

BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION as Executor of the Last Will and Testament of Elisha Cobb Mayo, Dec'd.,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION

The above named petitioner hereby petitions for redetermination of the deficiency set forth by the Commisioner of Internal Revenue in his notice of deficiency (Bureau Symbols: MT-ET-84-32-1st California) dated February 29, 1940, and as a basis of its proceeding alleges as follows:

1. The petitioner is a National Banking Association by law duly licensed to administer court and private trusts, and is the duly qualified and acting Executor of the Last Will and Testament of Elisha Cobb Mayo, deceased. That the said Estate is being administered at the Santa Rosa Branch of said Bank, in the City of Santa Rosa, County of Sonoma, State of California.

2. The notice of deficiency (a copy of which is attached and marked Exhibit "A") was mailed the petitioner on February 29, 1940.

3. The taxes in controversy are estate taxes. The [3] deficiency asserted is $5,971.61, all of which is in controversy.

4. The determination of taxes set forth in the said notice of deficiency is based upon the following errors:

(a) The inclusion in the gross estate of interest accrued on securities during the optional period contrary to the provisions of subdivision (j) of Section 302 of the Revenue Act of 1926, as amended by Section 202 of the Revenue Act of 1935 (now, Internal Revenue Code Section 811 (j)).

(b) Refusal of the respondent to allow as a deduction from the gross estate the amount of present values of all bequests contained in the Will of the decedent to certain organizations operated for charitable, religious, educational or other purposes as prescribed in Section 303 (a) (3) of the Revenue Act of 1926, as amended, (now, Internal Revenue Code, Section 811 (d)).

5. The facts upon which the petitioner relies

as the basis of this proceeding are as follows:

(a) Exhibit "A" and the Return Form 706 set forth the facts on the first assignment of error.

(b) Elisha Cobb Mayo died August 26, 1937 a resident of Santa Rosa, California. He left a Will, copy of which is hereto annexed and marked Exhibit "B". The Will provided for a devise to decedent's sister Rebecca S. Mayo of the family home at Number 20 Davis Street, Santa Rosa and a bequest of personal effects. The Davis Street home did not pass by the Will as a deed was executed to Rebecca S. Mayo dated November 17, 1919 but not recorded until September 2, 1937 which was after decedent's death. The value of this real property is included in the gross estate. The Will also provided for certain general cash [4] legacies which include California State Inheritance Taxes thereon, aggregating $3,699.45. Paragraph Sixth of the Will leaves all the residuary estate to petitioner in trust with full powers of management, investment and reinvestment. The third paragraph of Paragraph Sixth reads as follows:

> "From the said trust property my aforesaid trustee shall pay the sum of Two Hundred Fifty ($250.00) dollars per month to my sister Rebecca S. Mayo, said payments to run from the date of my death, and in case she should, by reason of accident, illness, or other unusual circumstances so require, such additional sum or sums as in the judgment of said trustee may be necessary and reasonable under the existing conditions. Upon the death of my

said sister the said trustee shall liquidate my entire estate and from the proceeds shall pay to the beneficiary hereinafter named the amounts hereinafter mentioned, to-wit: ''

All the twelve beneficiaries which follow, (a) to (l) inclusive, are admitted charities, within the meaning of Section 303 (a) (3) of the Revenue Act, as amended.

Rebecca S. Mayo, decedent's sister, was born October 5, 1858, and her nearest birthday on the date of her brother, Elisha Cobb Mayo's death was 79 years. Rebecca S. Mayo has been totally blind for many years and prior to her brother's death. She rarely leaves her home at 20 Davis Street in Santa Rosa; has and does live a simple and frugal life. Her health is fair for one of her years and all her expenses, living or medical, have, for the years immediately after her brother's death, not exceeded $100.00 a month. Prior to and on the date of the death of decedent, Rebecca S. Mayo's expenses were even less than $100.00 per month. Apart from the home at 20 Davis Street which she owns outright and free of mortgage or other encumbrance, Rebecca S. Mayo has an independent annual income which amounted to approxi- [5] mately $800.00 for the calendar year 1939 and is so shown upon her Federal Income Tax Return. She maintains three savings bank accounts in Santa Rosa and in the petitioner's branch, her savings account, which was opened October 6, 1938, has a present balance, March 5, 1940, of $3,702.78. There have been no withdrawals from said account and almost without ex-

ception there are monthly deposits of the $250.00 received from the Trustee under the terms of her brother, Elisha C. Mayo's Will.

The annual income from the trust of the residuary estate of Elisha C. Mayo has exceeded $5,000.00 for each of the years following his death. All payments to Rebecca S. Mayo under the trust or executorship have been paid from income and the accounts settled by the Superior Court so show. No payments have been, nor are contemplated being made from the corpus of the trust as provided in decedent's Will: " . . . in case she (Rebecca S. Mayo) should, by reason of accident, illness or other unusual circumstances so require, . . . " Indeed, no unusual payment has been made from surplus income, which under the terms of the Will is first called, except $58.83 in December 1938 in purchase of a Talking Book Machine produced by the American Foundation for the Blind, Inc.

Petitioner's Return Form 706, computed the value of the remainder interest to admitted exempt organizations to be $93,776.70. This figure resulted after first deducting from the gross estate: Administration expenses $5,323.22; Specific Bequests (cash legacies) $3,699.45; Value of Rebecca S. Mayo's annuity $11,811.53, computed according to the applicable Regu- [6] lations; and California State Inheritance Taxes $4,000.00. The respondent did not except to this computation by petitioner, but disallowed the entire amount. No tax will result in this proceeding, even taking the respondent's figures, as set forth in Exhibit "A",

unless the redetermination of this Board finds the deduction for charitable vested remainer interests to be less than $74,081.63. Said latter figure likewise excludes the value of Rebecca S. Mayo's annuity as computed above.

6. Wherefore, the petitioner prays that this Board may hear the proceedings and determine that there is no deficiency due from petitioner for Federal Estate taxes, in the Estate of Elisha Cobb Mayo, deceased.

EDWARD HALE JULIEN
Counsel for Petitioner

(Duly Verified.) [7]

EXHIBIT "A"

Treasury Department
Internal Revenue Service
San Francisco, Calif.
Feb. 29, 1940.

Office of
Internal Revenue Agent in Charge
433 Federal Office Bldg.
San Francisco Division

MT-ET-84-32-1st California
Estate of Elisha Cobb Mayo

Bank of America, N.T. & S.A., Executor
Santa Rosa, California

Gentlemen:

You are advised that the determination of the estate tax liability of the above-named estate, dis-

closes a deficiency of $5,971.61, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within ninety days (not counting Sunday or a legal holiday in the District of Columbia as the ninetieth day) from the date of the mailing of this letter, you may file a petition with the United State Board of Tax Appeals for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to Internal Revenue Agent in Charge, 433 Federal Office Building, San Francisco, California for the attention of Chief Estate Tax Officer. The signing and filing of this form will expedite the closing of your return by permitting an early assessment of the deficiency and will prevent the accumulation of interest, since the interest period terminates thirty days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,
GUY T. HELVERING,
Commissioner.
By N. M. HARLESS
Internal Revenue Agent in
Charge

JR;emr
Enclosures:
Statement
Form of Waiver [8]

STATEMENT

In making this determination of the estate tax liability of the above-named estate, careful consideration has been given to your protest dated October 26, 1939 and to the statements made at the conference held January 17, 1940.

The deficiency results from the following adjustments:

GROSS ESTATE

Stocks and Bonds	Returned	Determined
Item 3	5,520.00	5,700.00
Item 12	45.00	90.00
Item 19	140.00	147.60
Item 20	12,425.00	12,780.00

The adjustments with respect to the above items are based on the mean between the high and low sales prices on the New York and San Francisco Stock Exchanges.

Mortgages, Notes and Cash		
Item 1	149.32	185.30
Item 2	30.00	72.71
Item 3	29.80	61.10

The above adjustments are due to interest accrued during the optional period.

DEDUCTIONS

Miscellaneous Administration Expenses	Returned	Determined
Item 1	250.00	153.64

The amount actually spent is allowed.

Charitable, Public and Similar Gifts and Bequests		
Item 1	93,776.70	0.00

The bequests to charity are disallowed as deduc-

tions because it appears from the decedent's will that the trustee was given the power thereunder to divert the trust funds to non-charitable purposes. See Article 47, Regulations 80.

In view of the foregoing, the Federal estate tax liability of this estate is finally determined as follows: [9]

	Determined	
Gross estate	$119,308.49	
Deductions (1926 Act)	105,226.86	
Net estate (1926 Act)	14,081.63	
Gross estate	119,308.49	
Deductions (1932 Act)	45,226.86	
Net estate (1932 Act)	74,081.63	
Gross tax (1926 Act)	140.82	
Credit for gift tax	0.00	
Gross tax less gift tax credit	140.82	
Credit for estate or inheritance tax	0.00	
Net tax (1926 Act)		140.82
Total gross taxes (1926 and 1932 Acts)	5,971.43	
Gross tax (1926 Act)	140.82	
Gross additional tax	5,380.61	
Credit for gift tax	0.00	
Net additional tax		5,380.61
Total net tax		5,971.43
Amount shown on return		0.00
Deficiency		5,971.61

The deficiency bears interest at the rate of six per cent per annum from fifteen months after decedent's death to the date of assessment, or to the thirtieth day after the filing of a waiver of the restrictions on the assessment, whichever is the earlier.

Upon receipt of a waiver or upon the expiration of ninety days from the date of this letter if a petition is not filed with the Board of Tax Appeals, $5,858.77 of the deficiency will be assessed. As the balance of the deficiency may be eliminated by credit for State or Territorial estate, inheritance, legacy or succession taxes, opportunity will be accorded for the submission of the evidence required by Article 9 of Estate Tax Regulations 80. If, after a resonable time the evidence is not filed, the balance of the deficiency will be assessed. Please advise when the submission of the evidence may be expected.

For Exhibit "B" See Exhibit "A" To Stip. Facts - Page 36.

[Endorsed]: U.S.B.T.A. Filed May 6, 1940. [10]

[Title of Board and Cause.]

ANSWER

Comes now the Commissioner of Internal Revenue, respondent above named, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal

Revenue, and for answer to the petition filed by the above-named petitioner, admits and denies as follows:

1. Admits the allegations contained in paragraph 1 of the petition.

2. Admits the allegations contained in paragraph 2 of the petition.

3. Admits the allegations contained in paragraph 3 of the petition.

4. (a) and (b) Denies that the determination of taxes set forth in the said notice of deficiency is based upon errors as alleged in paragraph 4 of the petition and subparagraphs thereunder. [11]

5. (a) Denies the allegations contained in subparagraph (a) of paragraph 5 of the petition.

(b) Admits that Elisha Cobb Mayo died August 26, 1937, a resident of Santa Rosa, California, and that he left a Will; for lack of information, and for other reasons, denies all other allegations contained in subparagraph (b) of paragraph 5 of the petition.

6. Denies generally and specifically each and every material allegations contained in the petition herein, not hereinbefore specifically admitted, qualified, or denied.

Wherefore, it is prayed that the Commissioner's determination be approved and that the petitioner's appeal be denied.

(Signed) J. P. WENCHEL
T. M. M.
Chief Counsel, Bureau of Internal Revenue.

Of Counsel:
Alva C. Baird,
T. M. Mather,
Arthur L. Murray,
Special Attorneys,
Bureau of Internal Revenue.
ALM/vg 6-10-40

[Endorsed]: U.S.B.T.A. Filed Jun. 17, 1940. [12]

Edward Hale Julien, Esq., for the petitioner.
Arthur L. Murray, Esq., for the respondent.

[Title of Board and Cause.]

MEMORANDUM FINDINGS OF FACT AND OPINION

The Commisioner has determined a deficiency in Federal estate taxes in the amount of $5,971.61 due from this petitioner. From the Commissioner's determination the taxpayer has appealed and instituted this proceeding.

The sole issue involved for our determination is whether bequests of certain specific remainder interests to charitable institutions under a testamentary trust are deductible in determining the net taxable estate of the settlor for estate tax purposes where decedent's sister has a prior [13] interest under the trust of $250 per month for life and the trustee may pay to her such further sums as it

deems reasonable and necessary in the event of accident, illness or other unusual circumstances.

FINDINGS OF FACT

The estate of Elisha Cobb Mayo, the Bank of America National Trust and Savings Association, Executor, is a decedent's estate with its address at Santa Rosa, California. It filed an estate tax return on behalf of the decedent's estate with the collector of internal revenue for the first division of California.

Elisha Cobb Mayo died testate on August 26, 1937. His will, subscribed to in Sonoma County, California, on April 3, 1937, contained, inter alia, the following provisions:

> Second: I hereby declare that my only near of kin is my sister Rebecca S. Mayo and her welfare is uppermost in my mind, and I request my Trustee hereinafter named to give her every care, advice and assistance possible.
>
> * * * * * *
>
> Fourth: I give, devise and bequeath to my sister Rebecca S. Mayo my house and lot * * * together with all household goods and personal property in said home contained.

Then follow certain specific bequests totaling $3,500 to various individuals and one for the perpetual care and upkeep of a cemetery plot, after which appears the provision about which this controversy centers.

> Sixth: I hereby give, devise and bequeath all the rest, residue and remainder of my es-

tate of whatsoever kind or character and wheresoever situated, to the Bank of America National Trust and Savings Association, a National Banking Association, (Santa Rosa Branch), to be held in trust for the following uses and purposes in relation to the same.

* * * * * * [14]

From the said trust property my aforesaid trustee shall pay the sum of Two Hundred Fifty ($250.00) dollars per month to my sister Rebecca S. Mayo, said payments to run from the date of my death, and in case she should, by reason of accident, illness, or other unusual circumstances so require, such additional sum or sums as in the judgment of said trustee may be necessary and reasonable under the existing conditions.

Upon the death of my said sister the said trustee shall liquidate my entire estate and from the proceeds shall pay to the beneficiary hereinafter named the amounts hereinafter mentioned, to-wit:

Here are specified bequests of $2,000 to each of the following (a) Millers River Hospital, (b) Sonoma County Tuberculosis Association, (c) Children's Home Society of 3595 66th Avenue, Oakland, California, (e) Sonoma County Social Service Department; also, bequests of $1,000 to each of the following: (d) the Blind Department of the California State Library at Sacramento, California, to be used for the purchase of books for the

blind, (f) the Santa Rosa Chapter of the American National Red Cross Society, and (g) the Santa Rosa Salvation Army. In addition there are provided specific bequests of $500 to each of the following: (h) the Santa Rosa Humane Society, (i) the Santa Rosa District of the Boy Scouts of America, and (j) the Santa Rosa Camp Fire Girls. An additional bequest of $20,000 is provided for the County of Sonoma to be used for the furnishing of rooms and accommodations at the Sonoma County Hospital for worthy and deserving indigent persons. It is provided that the residue of the trust estate is to go to the American National Red Cross Society.

The value of the gross estate of Elisha Cobb Mayo, deceased, com- [15] puted in accordance with the provisions of section 302 (j) of the Revenue Act of 1926, as amended by section 202 of the Revenue Act of 1935, was $114,853.37.

The undisputed deductions from gross estate, allowable under the applicable internal revenue Acts, exclusive of specific exemption, amount to $5,226.85.

On the Federal estate tax return filed for the Estate of Elisha Cobb Mayo, deceased, a deduction of $93,776.70 was claimed under the heading of "Charitable, public and similar gifts and bequests," which deduction was totally disallowed by the respondent.

It is agreed between the parties that all the organizations listed in paragraph Sixth of decedent's

will are of a charitable or public nature within the scope of the Federal internal revenue laws. It is also agreed between the parties that none of the bequests to these organizations (except as to the $1,000 to the California State Library, the $2,000 to the Sonoma County Social Service Department and the $20,000 to the County of Sonoma for rooms and accommodations for worthy poor persons), is of the type contemplated by section 42 of the California Probate Code as it was worded at the time of decedent's death.

The last will and testament of the decedent was admitted to probate on September 10, 1937, by the Superior Court of California, in and for the County of Sonoma. On February 3, 1938, Rebecca S. Mayo, sister of the decedent, and his only heir at law, executed a waiver with respect to the rights provided for and granted to her, in, by or under section 41 of [16] the California Probate Code. On April 15, 1938, the court made a decree of settlement of the first account and report and order of partial distribution. This decree has never been contested. On October 7, 1938, the court entered a decree settling the final account and for distribution, which decree has never been contested.

Rebecca S. Mayo, decedent's sister, was in her seventy-ninth year at the time of decedent's death. Her eyesight was then greatly impaired. In October 1935 an operation was performed on both her eyes for glaucoma, and in May 1936 an operation was performed on her right eye for a cataract. An

examination of her eyes made in August 1938 showed "Left eye—Hand motion three inches. Right eye approximately eighteen per cent vision."

At the time of decedent's death Rebecca S. Mayo owned the following property: (1) the home in which she lived, valued at $3,500; (2) stocks and bonds valued at approximately $16,000; and (3) savings bank accounts with deposits totaling $7,465.13. The income from these assets during 1937 was approximately $900. Her living expenses during 1937 for housekeeper, taxes, food, clothing and miscellaneous purposes were approximately $1,450.

The foregoing facts have all been stipulated by the parties and, in addition to those facts, the Board has made the following findings from evidence introduced at the hearing.

Since decedent's death the monthly payments of $250 to Rebecca Mayo have at all times been paid out of income of the trust corpus. The gross [17] income from the trust corpus (composed of stocks, bonds and a small amount of cash), for the year 1937 was $6,338.32 and, after deducting the difference between gains and losses on security sales, there was a net income of $4,814.67. The net income of the trust corpus in 1938 was $5,298.79 after deduction of state and Federal income taxes and losses on securities sold. In 1939 the net income was $3,995.77 after deduction of income taxes, administration expenses and losses on securities sold. In 1940 the net income was $4,872.51, after the usual deductions.

The accounts which the trustee filed annually with the court distinguished income and principal and always indicated Rebecca Mayo's $3,000 annual allowance as a charge against the income account.

Rebecca Mayo deposited in her savings account for accumulation the greater part of the $250 monthly payments made to her from the trust. Her activities at the time of her brother's death and thereafter were greatly restricted due to the condition of her eyesight and her advanced age.

OPINION

Kern:

Since the briefs were filed by the parties in this case, the Board has decided the case of Estate of Ozro Miller Field, 45 B.T.A. —— (promulgated October 7, 1941), where, on somewhat comparable facts, a decision was rendered in favor of the taxpayer. If there is any material difference between the ultimate material facts in that case and the present proceedings it would seem to be in the present petitioner's favor. Our decision in the cited case is controlling here.

Respondent has urged that the present case is comparable to Gammons et al v Hasset, 121 Fed. (2d) 229, where the Circuit Court of Appeals, [18] First Circuit, disallowed a deduction for charitable gifts. Although this case was not specifically mentioned in our decision in the Field case, supra, certain language in our decision of that case disposes of respondent's contention. We said at page

—: "Cases where the beneficiary was not restricted in any way and cases where annuities for after-born children might consume the corpus are not in point."

In the instant case, as in the Field case, supra, it was the trustee not the beneficiary, who had the right under certain circumstances, to invade the corpus to provide more income for the life beneficiary. In the instant proceedings the trustee is strictly limited to a situation where "by reason of accident, illness, or other unusual circumstances" the life beneficiary should "require" sums in addition to the payment of $250 per month. The income from the trust corpus could reasonably be expected to provide sufficient cash for the $250 monthly payments to decedent's sister. During the years of the trust's existence the income thereof has been considerably in excess of the amounts necessary to make these payments. And, since decedent's sister has to date saved the greater part of her annuity payments, it seems highly improbable that "accident, illness or other unusual circumstances" would necessitate the trustee delving into corpus or even surplus income.

Respondent, in this connection, however, contends that only a portion of the charitable bequests should, in any event, be deductible, that is, [19] not to exceed one-third of the net estate plus the value of the bequests to the California State Library and the Sonoma County Social Service Department. This argument is not based upon

the nature of the bequests but upon the premise that the testator was precluded by certain California statutes from making devises to the other charities or in trust for those other charities in an amount which would call for the payment for that purpose of more than one-third of his net estate, citing sections 41 and 42 of the California Probate Code.[1] Respondent, however, does not

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[1]Section 41. Restriction on Devises for Charitable Uses. No estate, real or personal, may be bequeathed or devised to any charitable or benevolent society or corporation, or to any person or persons in trust for charitable uses, unless done by will duly executed at least thirty days before the death of the testator. If so made at least 30 days before death, such devises and legacies shall be valid, but they may not collectively exceed one-third of the estate of a testator who leaves legal heirs, and if they do, a pro rata deduction from such devises and legacies shall be made so as to reduce the aggregate thereof to one-third of the estate. All dispositions of property made contrary hereto shall be void, and go to the residuary legatees or devisees or heirs, according to law.

Section 42. Exemption of certain donees from restrictions. Bequests and devises to or for the use of or benefit of the State, or any municipality, county or political subdivision within the State, or any institution belonging to the State, or belonging to any municipality, county or political subdivision within the State, or to any educational institution which is exempt from taxation under section 1a of Article XIII or section 10 of Article IX of the constitution of this State and statutes enacted thereunder, or for the use or benefit of any such educational institution, or to any corporation organized under the provisions of section 606 of the Civil Code or made by a testator leaving no spouse,

urge that provisions in a testamentary trust, which seek to distribute more than one-third [20] of the estate to charities are void. He argues that they are voidable, and contends that those portions which are voidable due to the terms of section 41 of the California Probate Code, supra, do not constitute allowable deductions. Petitioner admits that certain of the provisions may have been voidable but contends that they were not void. Inasmuch, therefore, as both parties agree that they were voidable, we will conduct no search into the question of whether, under the decisions of the California courts, they may have been void.

Respondent's reliance on our decision in Estate of Valentine Janson, 3 B.T.A. 296, is futile since that case dealt with a statute which, at the hearing, was admitted by counsel for the taxpayer to have been interpreted by the State courts as declaring void (not voidable) the charitable bequests there involved. A better analogy of our present situation was considered in Commissioner of Internal Revenue v. First National Bank of Atlanta et al, 102 Fed (2d) 129, wherein the Circuit Court of Appeals, Fifth Circuit, upheld the Board's decision set forth in 36 B.T.A. 491. In the latter case a resident of Georgia died leaving a will executed

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brother, sister, nephew, niece, descendant or ancestor surviving by whom the property so bequeathed or devised would have been taken if said property had not been so bequeathed or devised, are excepted from the restrictions of this Article.

89 days before his death in which he provided for certain charitable bequests. By instrument dated a week after his death his widow and only surviving child renounced all rights they might have under the Georgia statutes to contest these bequests. There was at the time in effect a Georgia statute [21] declaring that where a testator left surviving him a wife or child he could not devise any of his estate to charities unless the will was executed at least 90 days prior to his death, "or such devise shall be void."

Where persons are entitled by a State statute to assert claims in avoidance of certain provisions of a will, but fail and refuse so to do, the statute can not subsequent to the state court's decree be invoked by third persons, (here the Commissioner of Internal Revenue), for the purpose of avoiding the provisions already decreed by the state court to be valid and operative.

> If read according to its terms, the bequests are definite, certain, unequivocal and final from the standpoint of the testator's desire and will, and unobjected to, they stand as valid as against those having right to contest or object to them, they stand also as valid and definite for the purposes of taxation. * * *
>
> We are in agreement with these views. * * * [Commissioner of Internal Revenue v. First National Bank of Atlanta et al, 102 Fed. (2d) 129.]

Since these charitable bequests were not chal-

lenged by petitioner's sister, and have been held valid by a court of competent jurisdiction, we hold that they are deductible from decedent's gross estate.

Enter:

Decision will be entered under Rule 50.

Entered Nov. 17, 1941. [22]

United States Board of Tax Appeals
Washington

Docket No. 102469

BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION, as Executor of the Last Will and Testament of Elisha Cobb Mayo, deceased,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the memorandum findings of fact and opinion of the Board entered November 17, 1941, the respondent herein on December 10, 1941 having filed a recomputation of tax and the petitioner on December 27, 1941 having filed an agreement to such recomputation, now, therefore, it is

Ordered and Decided: That there is no defi-

ciency in estate tax due from, or overpayment due to, this petitioner.

(Signed) JOHN W. KERN,
Member.

Enter:

Entered Dec. 30, 1941. [23]

[Title of Circuit Court of Appeals and Cause.]

PETITION FOR REVIEW

Guy T. Helvering, United States Commissioner of Internal Revenue, holding office by virtue of the laws of the United States, hereby petitions the United States Circuit Court of Appeals for the Ninth Circuit to review the decision entered by the United States Board of Tax Appeals on December 30, 1941 that there is no deficiency in estate tax due from the Estate of Elisha Cobb Mayo, deceased (date of death August 26, 1937). This petition for review is filed pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

The Bank of America National Trust and Savings Association at Santa Rosa, California, is the duly appointed, qualified and acting executor of the will of the decedent. The Estate Tax Return made on behalf of the decedent's estate, was filed with the Collector of Internal Revenue for the First District of California, whose office is located at San Francisco, California, which is within the jurisdiction of the United States Circuit Court of Appeals for the Ninth Circuit. [24]

NATURE OF CONTROVERSY

The decedent, under the provisions of his will, placed his residuary estate in trust. The income from the corpus to the extent of $250.00 a month, was directed to be paid to the decedent's sister for life, with remainder to charitable organizations. The trustee of the trust estate was authorized to invade the principal of the trust for the benefit of the decedent's sister in the event of accident, illness or other unusual circumstances so required.

In the Estate Tax Return made on behalf of the decedent's estate, the executor claimed a deduction from the gross estate in the amount of the value of the remainder interest in the corpus of the trust as a bequest to charitable organizations. In determining the deficiency in the estate tax, the Commissioner disallowed the claimed deduction because the right to invade the trust corpus made it impossible to determine the amount of the value of the trust corpus, if any, that would eventually pass to charity.

The Memorandum Findings of Fact and Opinion of the Board of Tax Appeals was entered November 17, 1941, in which the Board erroneously held that the estate was entitled to the claimed deduction above referred to; and the final order of redetermination of the deficiency was entered December 30, 1941 in which the Board erroneously ordered that there was no deficiency in the estate tax.

ASSIGNMENTS OF ERROR

The Commissioner of Internal Revenue, being aggrieved by the conclusions of law contained in the decision of the Board of Tax Appeals and [25] by its order of redetermination of the deficiency in estate tax, desires to obtain a review thereof by the United States Circuit Court of Appeals for the Ninth Circuit.

The Commissioner's assignments of error are as follows:

1. The Board of Tax Appeals erred in holding and deciding that the estate is entitled to a deduction from the decedent's gross estate of the amount of the value of the remainder interest in the residuary trust estate created under the decedent's will, as a bequest to charitable organizations.

2. The Board of Tax Appeals erred in not holding and deciding that the estate is not entitled to a deduction from the decedent's gross estate of the amount of the value of the remainder interest in the residuary trust estate created under the decedent's will, as a bequest to charitable organizations.

3. The Board of Tax Appeals erred in entering its order of redetermination that there is no deficiency in estate tax due from or overpayment due to the petitioner.

4. The Board of Tax Appeals erred in failing and refusing to enter its order of redetermination that there is a deficiency in estate tax due from

the estate of the decedent in the amount asserted by the Commissioner.

(Sgd.) SAMUEL O. CLARK, JR.,
Assistant Attorney General.

(Sgd.) J. P. WENCHEL,
R.L.W.
Chief Counsel, Bureau of Internal Revenue,
Attorneys for Petitioner on Review.

RFS-spt 3-14-42

[Endorsed]: U.S.B.T.A. Filed Mar. 14, 1942. [26]

[Title of Circuit Court of Appeals and Cause.]

NOTICE OF FILING PETITION FOR REVIEW

To: Bank of America National Trust and Savings Association, Executor, of the Last Will and Testament of Elisha Cobb Mayo, dec'd., Santa Rosa, California.

You are hereby notified that the Commissioner of Internal Revenue did, on the 14th day of March, 1942, file with the Clerk of the United States Board of Tax Appeals, at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Ninth Circuit, of the decision of the Board heretofore rendered in the above-entitled case. A copy of the petition for review and the assignments of error as filed is hereto attached and served upon you.

Dated this 14th day of March, 1942.

(Signed) J. P. WENCHEL,
R.L.W.
Chief Counsel, Bureau of Internal Revenue.

Personal service of the above and foregoing notice, together with a copy of the petition for review and assignments of errors mentioned therein, is hereby acknowledged this 19th day of March, 1942.

(Signed) JAS. T. MEILIKE
Respondent on Review,
Trust Officer, Bank of America N. T. & S. A.

Spt 3-14-42

[Endorsed]: U.S.B.T.A. Filed Mar. 25, 1942. [27]

[Title of Circuit Court of Appeals and Cause.]

NOTICE OF FILING PETITION FOR REVIEW

To: Edward Hale Julien, Esq., Mills Building, San Francisco, California.

You are hereby notified that the Commissioner of Internal Revenue did, on the 14th day of March, 1942, file with the Clerk of the United States Board of Tax Appeals, at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Ninth Circuit, of the decision of the Board heretofore rendered in the above-entitled case. A copy of the petition for review and the

assignments of error as filed is hereto attached and served upon you.

Dated this 14th day of March, 1942.

(Signed) J. P. WENCHEL
R.L.W.
Chief Counsel, Bureau of Internal Revenue.

Personal service of the above and foregoing notice, together with a copy of the petition for review and assignments of errors mentioned therein, is hereby acknowledged this 20th day of March, 1942.

(Signed) EDWARD HALE JULIEN
Attorney for Respondent on Review.

Spt 3-4-42

[Endorsed]: U.S.B.T.A. Filed Mar. 25, 1942. [28]

[Title of Circuit Court of Appeals and Cause.]

STATEMENT OF POINTS

Now Comes Guy T. Helvering, Commissioner of Internal Revenue, the petitioner on review herein, by and through his attorneys, Samuel O. Clark, Jr., Assistant Attorney General, and J. P. Wenchel, Chief Counsel, Bureal of Internal Revenue, and hereby asserts the following errors on which he intends to rely:

1. The Board of Tax Appeals erred in holding and deciding that the estate is entitled to a deduction from the decedent's gross estate of the amount of the value of the remainder interest in the residu-

ary trust estate created under the decedent's will, as a bequest to charitable organizations.

2. The Board of Tax Appeals erred in not holding and deciding that the estate is not entitled to a deduction from the decedent's gross estate of the amount of the value of the remainder interest in the residuary trust estate created under the decedent's will, as a bequest to charitable organizations.

3. The Board of Tax Appeals erred in entering its order of redetermination that there is no deficiency in estate tax due from or overpayment [29] due to the petitioner.

4. The Board of Tax Appeals erred in failing and refusing to enter its order of redetermination that there is a deficiency in estate tax due from the estate of the decedent in the amount asserted by the Commissioner.

(Signed) SAMUEL O. CLARK, JR.
Assistant Attorney General.

(Signed) J. P. WENCHEL
R. L. W.
Chief Counsel, Bureau of Internal Revenue.

Service of a copy of the within Statement of Points is hereby admitted this 20th day of July, 1942.

EDWARD HALE JULIEN,
Mills Building,
San Francisco, California,
Attorney for Respondent on Review.

Spt 7-13-42

[Endorsed]: U.S.B.T.A. Filed July 28, 1942. [30]

United States Board of Tax Appeals

Docket No. 102469

BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION, as Executor of the Last Will and Testament of Elisha Cobb Mayo, Deceased,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

STIPULATION OF FACTS

It is hereby stipulated and agreed by and between the parties hereto, through their respective counsel, that the facts as hereinafter stated shall be taken as true and that either party may prove such additional facts as may be relevant and material and not inconsistent with those hereby stipulated.

I. Estate of Elisha Cobb Mayo, The Bank of America National Trust and Savings Association, Executor, is a decedent's estate with its address at Santa Rosa, California.

II. Elisha Cobb Mayo died testate on August 26, 1937. A full true and correct copy of the last will and testament of Elisha Cobb Mayo, deceased, is attached hereto and made a part hereof and marked Exhibit "A". [31]

III. The value of the gross estate of Elisha Cobb Mayo, deceased, computed in accordance with the provisions of subdivision (j) of section 302 of the Revenue Act of 1926, as amended by section 202 of the Revenue Act of 1935, was $114,853.37.

IV. The undisputed deductions from gross estate, allowable under the applicable Internal Revenue Acts, exclusive of specific exemption, amount to $5,226.85.

V. On the Federal estate tax return filed for the Estate of Elisha Cobb Mayo, deceased, a true and correct copy of which will be introduced into evidence, a deduction of $93,776.70 was claimed under the heading of "Charitable, Public, and Similar Gifts and Bequests", which deduction was totally disallowed by the respondent, as shown by the deficiency notice, a correct copy of which is attached to the petition.

VI. It is agreed that all the organizations listed as Items (a) to (l), inclusive, of paragraph Sixth of decedent's will, are of a charitable or public nature, within the meaning of the applicable Federal internal revenue laws. It is agreed that Items (a), (b), (c), (f), (g), (h), (i), (j) and (l), of paragraph Sixth of decedent's will, do not involve bequests of the type contemplated by section 42 of the California Probate Code as it was worded at the time of decedent's death.

VII. The last will and testament of Elisha Cobb Mayo was admitted to probate on September 10, 1937, by the Superior Court of California, in and for the County of Sonoma. On February 3, 1938, Rebecca S. Mayo, sister of the decedent and his only heir-at-law, [32] executed a waiver with respect to the rights provided for and granted to her, in, by or under Section 41 of the California Probate Code, a copy of which waiver is attached hereto and made a part hereof and marked Exhibit "B".

VIII. On April 15, 1938, the said Court made a Decree of Settlement of First Account and Report and Order of Partial Distribution, a correct copy of which is attached hereto and made a part hereof and marked Exhibit "C". Said decree has never been contested.

IX. On October 7, 1938, the said Court entered a Decree Settling Second and Final Account and For Distribution, a correct copy of which is attached hereto and made a part hereof and marked Exhibit "D". The said decree has never been contested.

X. Rebecca S. Mayo, sister of the decedent, was born on October 5, 1858, and her nearest birthday at the time of decedent's death was her seventy-ninth.

XI. At the time of decedent's death the eyesight of his sister, Rebecca S. Mayo, was greatly impaired. During October, 1935, an operation was performed on both her eyes for glaucoma. During May, 1936, a second operation was performed on her right eye for cataract. An examination of her eyes made during August of 1938 showed "Left eye—Hand motion 3 inches." "Right eye approximately 18 per cent vision."

XII. At the time of decedent's death his sister, Rebecca S. Mayo, owned the following property, (1) the home in which she lived, valued at $3500.00; (2) stocks and bonds, valued at approximately $16,000.00; and (3) savings bank accounts with deposits of $7465.13. [33] The income from said stocks,

bonds and savings accounts, during 1937, was approximately $900.00. Rebecca S. Mayo's living expenses during 1937 for housekeeper, taxes, food, clothing and miscellaneous were approximately $1450.00.

EDWARD HALE JULIEN
Counsel for Petitioner.

J. P. WENCHEL
Chief Counsel, Bureau of Internal Revenue, Counsel for Respondent. [34]

EXHIBIT "A"

Last Will and Testament of Elisha C. Mayo

I, Elisha C. Mayo, of the City of Santa Rosa, County of Sonoma, State of California, being of sound and disposing mind and memory and not acting under duress, menace, fraud, or the undue influence of any person whomsoever, do make, publish, and declare this to be my last Will and Testament in manner following, that is to say:

First: I hereby direct my executor hereinafter named to pay all my just debts and funeral expenses as soon after my death as can be lawfully and conveniently done.

Second: I hereby declare that my only near of kin is my sister Rebecca S. Mayo and her welfare is uppermost in my mind, and I request my Trustee hereinafter named to give her every care, advice and assistance possible.

Third: I hereby further declare that there may be living descendants of my father's brothers and sisters and of cousins of my mother, but I know

little of them, do not know how many of them there are, and have never seen the most of them, and I therefore make no bequests or provisions for them, but in the event that any such relative should establish his right to share in my estate, I do hereby bequeath to such relative or relatives the sum of ONE ($1.00) Dollar each, and no more.

Fourth: I give, devise and bequeath to my sister, Rebecca S. Mayo my house and lot at number 20 Davis Street, in the City of Santa Rosa, State of California, together with all household goods and personal property in said home contained.

Fifth: I give and bequeath the following amounts to the beneficiaries hereinafter named, viz:

(a) The sum of $500.00 to the Shilo Cemetery District, near Windsor, California, for the perpetual care and upkeep of Lot 46X.

(b) The sum of $500.00 to Mrs. Eliza M. Robbins, of Windsor, California.

(c) The sum of $500.00 to Mrs. Amy Hughes Gordon, of 622 Charles Street, Santa Rosa, California;

(d) The sum of $500.00 to Mr. and Mrs. Oscar A. Smythe, or to the survivor of them, of 25 Davis Street, Santa Rosa, California. [35]

(e) The sum of $500.00 to Mrs. C. C. Cragin, of 999 Sonoma Avenue, Santa Rosa, California;

(f) The sum of $500.00 to Mrs. Edith Frutiger, of Route 2, Box 29, Petaluma, California.

(g) The sum of $500.00 to Miss Lorae A. Jones, of Potter Valley, Mendocino County, California.

It is my desire that there be paid out of my es-

tate any inheritance tax which may be chargeable against the bequests given to the individuals hereinabove named, exclusive of Shilo Cemetery District, so that each of them may receive the full sum of $500.00 free from any taxes or deductions, to be paid as soon after my death as possible.

Sixth: I hereby give, devise and bequeath all the rest, residue and remainder of my estate of whatsoever kind or character and wheresoever situated, to the Bank of America National Trust and Savings Association, a National Banking Institution, (Santa Rosa Branch), to be held in trust for the following uses and purposes in relation to the same.

Said Trustee is hereby vested with full power and authority in its discretion to retain said property in the same form as it is received by it and is authorized to hold, mortgage, invest and reinvest the trust property in such manner and in such character of property as it may deem advisable; to borrow money for the benefit of the trust, to sell or to encumber the trust property, or any part thereof, by pledge, mortgage, Deed of Trust, or otherwise, and to improve, repair or exchange the trust property in such manner and upon such terms and conditions as the trustee may deem advisable. The trustee may participate in reorganization, consolidations, mergers, liquidations or foreclosures and shall pay out of the trust property, or gross income, all taxes, assessments, premiums, costs, charges, fees and expenses of every character incurred or expended in the care, collection, administration, protection, sale or distribution of the property, or in connection therewith. The powers of the trustee

herein conferred shall be cumulative and in addition to the powers conferred upon and granted to it by law.

From the said trust property my aforesaid trustee shall pay the sum of Two Hundred Fifty ($250.00) dollars per month to my sister Rebecca S. Mayo, said payments to run from the date of my death, and in case she should, by reason of accident, illness, or other unusual circumstances so require, such additional sum or sums as in the judgment of said trustee may be necessary and reasonable under the existing conditions.

Upon the death of my said sister the said trustee shall liquidate my entire estate and from the proceeds shall pay to the beneficiary hereinafter named the amounts hereinafter mentioned, to-wit:

(a) The sum of $2000.00 to Millers River Hospital at Winchendon, Worcester County, State of Massachusetts; [36]

(b) The sum of $2000.00 to the Sonoma County Tuberculosis Association;

(c) The sum of $2000.00 to Children's Home Society of 3595 66th Avenue, Oakland, California;

(d) The sum of $1000.00 to the Blind Department of the California State Library at Sacramento, California, to be used for the purchase of books for the blind;

(e) The sum of $2000.00 to the Sonoma County Social Service Department.

(f) The sum of $1000.00 to the Santa Rosa Chapter of the American National Red Cross Society.

(g) The sum of $1000.00 to the Santa Rosa Salvation Army.

(h) The sum of $500.00 to the Santa Rosa Humane Society.

(i) The sum of $500.00 to the Santa Rosa District of the Boy Scouts of America.

(j) The sum of $500.00 to the Santa Rosa Camp Fire Girls.

(k) The sum of $20,000.00 to the County of Sonoma to be used for the furnishing of rooms and accommodations at the Sonoma County Hospital for worthy and deserving indigent persons.

(l) All the rest, residue and remainder of my trust estate shall go to the American National Red Cross Society.

Seventh: I recommend to the executor of this will and the Trustee appointed hereunder, that it employ H. W. A. Weske, Attorney-at-Law, of the City of Santa Rosa, State of California, as its attorney in all matters requiring legal assistance hereunder.

Lastly: I hereby nominate and appoint Bank of America National Trust and Savings Association, a National Banking Association (Santa Rosa Branch), the executor of this my last Will and Testament, and as trustee under this Will.

In Witness Whereof, I have hereunto set my hand this 3rd day of April, 1937, at the City of Santa Rosa, County of Sonoma, State of California.

ELISHA C. MAYO.

The foregoing instrument, consisting of four pages, besides this one, was, on the day it bears date,

by the said Elisha C. Mayo signed, published as, and declared to be his last will and testament, in the presence of us, who, at his request, in his presence, and in the presence of each other, have subscribed our names as witnesses thereto.

H. W. A. WESKE
Residing at 721 Spring Street,
Santa Rosa, Calif.

DORIS J. OLSEN
Residing at 238 Carillo Street,
Santa Rosa, Calif.

[Endorsed]: U.S.B.T.A. Filed Jun. 16, 1941. [37]

In the United States Circuit Court of Appeals for the Ninth Circuit

B.T.A. Docket No. 102469

GUY T. HELVERING, Commissioner of Internal Revenue,

Petitioner on Review

v.

BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION, As Executor of the Last Will and Testament of Elisha Cobb Mayo, deceased,

Respondent on Review

DESIGNATION FOR RECORD

To the Clerk of the United States Board of Tax Appeals:

You will please prepare, transmit and deliver to

the Clerk of the United States Circuit Court of Appeals for the Ninth Circuit, copies duly certified as correct of the following documents and records in the above-entitled cause in connection with the petition for review by the said Circuit Court of Appeals for the Ninth Circuit, heretofore filed by the Commissioner of Internal Revenue:

1. Docket entries of the proceedings before the Board;
2. Pleadings before the Board:
   (a) Petition, including annexed copy of deficiency letter;
   (b) Answer.
3. Memorandum findings of fact and opinion, and decision of the Board;
4. Petition for review, together with proof of service of notice of filing petition for review and of service of a copy of petition for review;
5. Stipulation of Facts, including Exhibit "A", but excluding Exhibits "B", "C" and "D".
6. Statement of Points to be relied upon by petitioner on review. [38]
7. Orders enlarging time for the preparation of the evidence and for the transmission and delivery of the record. [Not included in record.]
8. This Designation for Record.

(Signed) J. P. WENCHEL
R. L. W.
Chief Counsel, Bureau of Internal Revenue.

Service of a copy of the within Designation for

Record is hereby admitted this 20th day of July, 1942.

Agreed to:

EDWARD HALE JULIEN
Mills Building,
San Francisco, California,
Attorney for Respondent on Review.

Spt 7-13-42

[Endorsed]: U.S.B.T.A. Filed July 28, 1942. [39]

United States Board of Tax Appeals
Washington

Docket No. 102469

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION, as Executor of the Last Will and Testament of Elisha Cobb Mayo, Dec'd.,
Respondent.

CERTIFICATE OF CLERK TO TRANSCRIPT OF RECORD

I, B. D. Gamble, clerk of the U. S. Board of Tax Appeals, do hereby certify that the foregoing pages, 1 to 39, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on

file and of record in my office as called for by the Praecipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of the United States Board of Tax Appeals, at Washington, in the District of Columbia, this 29th day of July, 1942.

[Seal] B. D. GAMBLE
Clerk,
United States Board of Tax Appeals.

[Endorsed]: No. 10213. United States Circuit Court of Appeals for the Ninth Circuit. Commissioner of Internal Revenue, Petitioner, vs. Bank of America National Trust and Savings Association, as Executor of the Last Will and Testament of Elisha Cobb Mayo, deceased, Respondent. Transcript of the Record. Upon Petition to Review a Decision of the United States Board of Tax Appeals.

Filed August 3, 1942.

PAUL P. O'BRIEN
Clerk of the United States Circuit Court of Appeals for the Ninth Circuit.

In the United States Circuit Court of Appeals
For the Ninth Circuit.

C. C. A. 9th No. 10213
B. T. A. Docket No. 102469

GUY T. HELVERING, Commissioner of Internal Revenue,

Petitioner on Review,

v.

BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION, As Executor of the Last Will and Testament of Elisha Cobb Mayo, deceased,

Respondent on Review.

DESIGNATION OF PARTS OF RECORD FOR CONSIDERATION.

The petitioner, Guy T. Helvering, Commissioner of Internal Revenue, hereby designates the entire record, including the statement of points, for consideration upon appeal and review of this case.

SAMUEL O. CLARK, JR.,
Assistant Attorney General.

Copy served on Edward Hale Julien, Esq., Mills Building, San Francisco, California, Attorney for respondent on review.

[Endorsed]: Filed Aug. 17, 1942, Paul P. O'Brien, Clerk.

No. 10213

In the United States Circuit Court of Appeals for the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION, AS EXECUTOR OF THE LAST WILL AND TESTAMENT OF ELISHA COBB MAYO, DECEASED, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR THE PETITIONER

SAMUEL O. CLARK, Jr.,
Assistant Attorney General.

SEWALL KEY,
HELEN R. CARLOSS,
MORTON K. ROTHSCHILD,
Special Assistants to the Attorney General.

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CITATIONS

In the United States Circuit Court of Appeals for the Ninth Circuit

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BRIEF FOR THE PETITIONER

OPINION BELOW

The only previous opinion in the present case is that of the United States Board of Tax Appeals (R. 14–25) which is a memorandum opinion and, therefore, not officially reported.

JURISDICTION

This petition for review (R. 26–29) involves federal estate taxes due from the estate of Elisha Cobb Mayo who died testate on August 26, 1937. On February 29, 1940, the Commissioner of Internal Revenue mailed to the respondent, as executor of the decedent's estate, a notice of a deficiency in the amount of $5,971.61.

(R. 8–12.) Within 90 days thereafter, and on May 6, 1940, the respondent, the decedent's executor, filed a petition with the Board of Tax Appeals for a redetermination of that deficiency under the provisions of Section 871 of the Internal Revenue Code. (R. 1, 3–12.) The decision of the Board of Tax Appeals that there was no deficiency was entered December 30, 1941. (R. 25–26.) The case is brought to this Court by a petition for review filed on March 14, 1942 (R. 26–29), pursuant to the provisions of Sections 1141–1142 of the Internal Revenue Code.

QUESTION PRESENTED

A testator left his property in trust to pay to his sister an annuity of $3,000 in monthly payments, with power in the trustee to pay the annuitant additional sums in case of accident, illness, or other unusual circumstances, with remainder at his sister's death to certain charities. The question presented is:

Whether the amount of the bequest to the charities was ascertainable at the date of the testator's death under Section 303 of the Revenue Act of 1926, as amended, and the applicable Treasury Regulations, despite the possibility of invading the trust corpus in order to make the annuity payments and despite the trustee's unrestricted power to invade the trust corpus to pay the annuitant additional sums in case of accident, illness, or other unusual circumstances.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved may be found in the Appendix, *infra*, pp. 25–27.

STATEMENT

The facts, some of which were stipulated (R. 33–41), and as found by the Board of Tax Appeals (R. 15–20), are substantially as follows:

The estate of Elisha Cobb Mayo, the Bank of America National Trust and Savings Association, executor, is a decedent's estate with its address at Santa Rosa, California. It filed an estate tax return on behalf of the decedent's estate with the Collector of Internal Revenue for the First Division of California. (R. 15.)

Elisha Cobb Mayo died testate on August 26, 1937. His will, subscribed to in Sonoma County, California, on April 3, 1937, contained, *inter alia,* the following provisions (R. 15):

> Second: I hereby declare that my only near of kin is my sister Rebecca S. Mayo and her welfare is uppermost in my mind, and I request my Trustee hereinafter named to give her every care, advice and assistance possible.
>
> * * * * *
>
> Fourth: I give, devise and bequeath to my sister Rebecca S. Mayo my house and lot * * * together with all household goods and personal property in said home contained.

Then follow certain specific bequests totaling $3,500 to various individuals and one for the perpetual care and upkeep of a cemetery plot, after which appears the provision about which this controversy centers (R. 15–16):

> Sixth: I hereby give, devise and bequeath all the rest, residue and remainder of my estate of whatsoever kind or character and wheresoever

situated, to the Bank of America National Trust and Savings Association, a National Banking Association, (Santa Rosa Branch), to be held in trust for the following uses and purposes in relation to the same.

* * * * *

From the said trust property my aforesaid trustee shall pay the sum of Two Hundred Fifty ($250.00) dollars per month to my sister Rebecca S. Mayo, said payments to run from the date of my death, and in case she should, by reason of accident, illness, or other unusual circumstances so require, such additional sum or sums as in the judgment of said trustee may be necessary and reasonable under the existing conditions.

Upon the death of my said sister the said trustee shall liquidate my entire estate and from the proceeds shall pay to the beneficiary hereinafter named the amounts hereinafter mentioned, to wit:

Here are specified bequests of $2,000 to each of the following (a) Millers River Hospital, (b) Sonoma County Tuberculosis Association, (c) Children's Home Society of 3595 66th Avenue, Oakland, California, (e) Sonoma County Social Service Department; also, bequests of $1,000 to each of the following: (d) The Blind Department of the California State Library at Sacramento, California, to be used for the purchase of books for the blind, (f) the Santa Rosa Chapter of the American National Red Cross Society, and (g) the Santa Rosa Salvation Army. In addition there are provided specific bequests of $500 to each of the following: (h) The Santa Rosa Humane Society, (i) the Santa Rosa District of the Boy Scouts of America,

and (j) the Santa Rosa Camp Fire Girls. An additional bequest of $20,000 is provided for the County of Sonoma to be used for the furnishing of rooms and accommodations at the Sonoma County Hospital for worthy and deserving indigent persons. It is provided that the residue of the trust estate is to go to the American National Red Cross Society. (R. 16–17.)

The value of the gross estate of Elisha Cobb Mayo, deceased, computed in accordance with the provisions of Section 302 (j) of the Revenue Act of 1926, as amended by Section 202 of the Revenue Act of 1935, was $114,853.37. (R. 17.)

The undisputed deductions from gross estate, allowable under the applicable Revenue Acts, exclusive of specific exemption, amount to $5,226.85. (R. 17.)

On the federal estate tax return filed for the estate of Elisha Cobb Mayo, deceased, a deduction of $93,-776.70 was claimed under the heading of "Charitable, public and similar gifts and bequests," which deduction was totally disallowed by the Commissioner. (R. 17.)

It is agreed between the parties that all the organizations listed in paragraph Sixth of decedent's will are of a charitable or public nature within the scope of the federal internal revenue laws. It is also agreed between the parties that none of the bequests to these organizations (except as to the $1,000 to the California State Library, the $2,000 to the Sonoma County Social Service Department and the $20,000 to the County of Sonoma for rooms and accommodations for worthy poor persons), is of the type contemplated by Section

42 of the California Probate Code as it was worded at the time of decedent's death. (R. 17–18.)

The last will and testament of the decedent was admitted to probate on September 10, 1937, by the Superior Court of California, in and for the County of Sonoma. On February 3, 1938, Rebecca S. Mayo, sister of the decedent, and his only heir at law, executed a waiver with respect to the rights provided for and granted to her, in, by or under Section 41 of the California Probate Code. On April 15, 1938, the court made a decree of settlement of the first account and report and order of partial distribution. This decree has never been contested. On October 7, 1938, the court entered a decree settling the final account and for distribution, which decree has never been contested. (R. 18.)

Rebecca S. Mayo, decedent's sister, was in her seventy-ninth year at the time of decedent's death. Her eyesight was then greatly impaired. In October, 1935, an operation was performed on both her eyes for glaucoma, and in May, 1936, an operation was performed on her right eye for a cataract. An examination of her eyes made in August, 1938, showed "Left eye—Hand motion three inches. Right eye approximately eighteen per cent vision." (R. 18–19.)

At the time of decedent's death Rebecca S. Mayo owned the following property: (1) The home in which she lived, valued at $3,500; (2) stocks and bonds valued at approximately $16,000; and (3) savings bank accounts with deposits totaling $7,465.13. The income from these assets during 1937 was approximately $900.

Her living expenses during 1937 for housekeeper, taxes, food, clothing and miscellaneous purposes were approximately $1,450. (R. 19.)

The foregoing facts have all been stipulated by the parties and, in addition to those facts, the Board has made the following findings from evidence introduced at the hearing. (R. 19.)

Since decedent's death the monthly payments of $250 to Rebecca Mayo have at all times been paid out of income of the trust corpus. The gross income from the trust corpus (composed of stocks, bonds and a small amount of cash), for the year 1937 was $6,338.32 and, after deducting the difference between gains and losses on security sales, there was a net income of $4,814.67. The net income of the trust corpus in 1938 was $5,298.79 after deduction of state and federal income taxes and losses on securities sold. In 1939 the net income was $3,995.77 after deduction of income taxes, administration expenses and losses on securities sold. In 1940 the net income was $4,872.51, after the usual deductions. (R. 19.)

The accounts which the trustee filed annually with the court distinguished income and principal and always indicated Rebecca Mayo's $3,000 annual allowance as a charge against the income account. (R. 20.)

Rebecca Mayo deposited in her savings account for accumulation the greater part of the $250 monthly payments made to her from the trust. Her activities at the time of her brother's death and thereafter were greatly restricted due to the condition of her eyesight and her advanced age. (R. 20.)

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STATEMENT OF POINTS TO BE URGED

The Board of Tax Appeals erred:

1. In holding that the estate is entitled to a deduction from the decedent's gross estate of the amount of the value of the remainder interest in the residuary trust estate created under the decedent's will, as a bequest to charitable organizations.

2. In holding that the amount of the value of the charitable gifts could be ascertained with reasonable accuracy at the date of the testator's death, although the trust estate was subject to an annuity and to additional payments to the annuitant in case of "accident, illness, or other unusual circumstances."

3. In holding that there is no deficiency in estate taxes due from the taxpayer.

SUMMARY OF ARGUMENT

In determining whether a bequest to charities is deductible from the gross estate of a decedent, the test laid down by the Treasury Regulations and the court decisions construing the statute is whether the amount of the bequest to the charities is ascertainable at the date of the death of the decedent. In this case the gift to charities was subject to some prior bequests which could not be reduced to definite sums of money. In his will the testator directed that certain property be left in trust from which the trustee was to pay $250 per month to his sister for the rest of her life and in case she should, by reason of accident, illness, or other unusual circumstances, so require such additional sum or sums as in the judgment of the trustee may be necessary and reasonable under the existing conditions.

The record shows that the income of the trust was sufficient for several years after the death of the decedent to pay the $3,000 annuity. But the decisions of the Supreme Court indicate that a deduction for a charitable gift will be allowed only if the value of the gift can be ascertained definitely at the date of the testator's death. As of that time it could not be said with absolute assurance that the trust income in this case would always be sufficient to pay the annuity. If it should be insufficient, the trustee was undoubtedly authorized to invade the corpus because the testator did not expressly or impliedly limit the annuity to payments out of trust income. Assuming, however, for the purposes of the argument that the trust income would be sufficient in all future years to take care of the annuity, there is no way in which we could ascertain with a reasonable degree of accuracy the accidents and illnesses that would befall the testator's sister during the remainder of her life and the amount of money that the trustee would be obliged to pay her on that account. The trust income did not exceed the annuity sufficiently that one could predict that the corpus would never be invaded. If the corpus should be invaded, there is no method of fixing the extent to which it will be invaded.

The weight of authority holds that the mere existence of the power to invade the corpus or the possibility of invasion is sufficient to defeat the deduction from gross income because under such circumstances it is impossible to ascertain the amount of the charitable bequest at the time of the testator's death.

ARGUMENT

The amount of the bequest to the charities was not ascertainable at the date of the testator's death under section 303 of the Revenue Act of 1926, as amended, and the applicable Treasury regulations, because of the trustee's unrestricted power to invade the trust corpus to pay the annuitant additional sums in case of accident, illness, or other unusual circumstances

In this case the decedent left a will in which he made certain specific bequests and an annuity of $250 per month to his sister and additional sums to his sister in case of accident, illness, or other unusual circumstances; upon the death of his sister the remainder of his estate to certain charitable and public organizations. (R. 16–17, 17–18.) The will provided in part as follows (R. 16):

> From the said trust property my aforesaid trustee shall pay the sum of Two Hundred Fifty ($250.00) dollars per month to my sister Rebecca S. Mayo, said payments to run from the date of my death, and in case she should, by reason of accident, illness, or other unusual circumstances so require, such additional sum or sums as in the judgment of said trustee may be necessary and reasonable under the existing conditions.
>
> Upon the death of my said sister the said trustee shall liquidate my entire estate and from the proceeds shall pay * * *.

Section 303 of the Revenue Act of 1926, as amended (Appendix, *infra*), provides in part that the value of the net estate shall be determined by deducting from the value of the gross estate the amount of all bequests, legacies, etc., to or for the use of the United States, any state, any political subdivision thereof, for exclusively

public purposes or to or for the use of any corporation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes.

Article 44, Treasury Regulations 80, relating to Section 303 of the Revenue Act of 1926 (Appendix, *infra*), provides in part that if a trust is created for both a charitable and a private purpose, deduction may be taken of the value of the beneficial interest in favor of the former only insofar as such interest is presently ascertainable, and hence severable in favor of the interest for private use. The validity of this regulation was approved by the Second Circuit in *Burdick* v. *Commissioner,* 117 F. 2d 972, 974, certiorari denied, 314 U. S. 641.

Article 47 of Treasury Regulations 80, relating to Section 303 of the Revenue Act of 1926, as amended (Appendix, *infra*), provides in part that if the legatee or trustee is empowered to divert the property or fund, in whole or in part, to a use or purpose which would have rendered it, to the extent that it is subject to such power, not deductible had it been directly so bequeathed, deduction will be limited to that portion, if any, of the property or fund which is exempt from an exercise of such power.

It is well established that the estate tax is not based upon the succession to property of legatees or devisees but is imposed upon the transmission of the property of the decedent at the date of his death. The tax attaches immediately upon the death of the decedent and the net estate must be determined as of that date. *Humes* v. *United States,* 276 U. S. 487; *Ithaca Trust*

Co. v. *United States,* 279 U. S. 151, 155; *United States* v. *Provident Trust Co.,* 291 U. S. 272; *Gammons* v. *Hassett,* 121 F. 2d 229 (C. C. A. 1st), certiorari denied, 314 U. S. 673.

Applying the statute and the regulations to the facts of this case, the principal question would seem to be whether the amount of the charitable bequests could be definitely ascertained as of the date of the decedent's death, in view of the fact that the trustee might invade the corpus in order to pay the annuity and also in case of accident, illness or other unusual circumstances. If the amount of the bequest could be definitely ascertained as of the date of the decedent's death, the charitable bequest is deductible; otherwise, it is not deductible.

In this case the testator died on August 26, 1937 (R. 15), at which time his sister was 79 years old (R. 18). He left a gross estate with a value of about $114,000. The undisputed deductions from the gross estate, exclusive of specific exemption, amounted to about $5,000. (R. 17.) This leaves a balance of about $109,000, out of which he left to his sister his house and lot and all household goods and personal property in his home; then followed certain specific bequests totaling $3,500 and one for the perpetual care and upkeep of a cemetery plot. (R. 15.) Therefore the residue which was left in trust (R. 15–16) could not have amounted to much more than $100,000. Out of this residue, the trustee was to pay $250 per month to his sister, the payments to run from the date of his death. (R. 16.) In other words, the residuary estate was first charged

with an annuity of $3,000 per year, payable in monthly installments to the testator's sister.

The net income for the estate for 1937 was about $4,800; for 1938, about $5,200; for 1939, about $3,900; for 1940, about $4,800. (R. 19.) If the annuity of $3,000 is subtracted from the net income, the balance of the income for 1937 was about $1,800; for 1938, about $2,200; for 1939, about $1,900, and for 1940, about $1,800. The record shows that the income of the trust was sufficient for several years after the death of the decedent to pay the $3,000 annuity. But the decisions of the Supreme Court indicate that a deduction for a charitable gift will be allowed only if the value of the gift can be ascertained definitely at the date of the testator's death. As of that time it could not be said with absolute assurance that the trust income in this case would always be sufficient to pay the annuity. If it should be insufficient, the trustee was undoubtedly authorized to invade the corpus because the testator did not expressly or impliedly limit the annuity to payments out of trust income. See *Burnet* v. *Whitehouse,* 283 U. S. 148, 151. But it is more important that under the terms of the trust, the trustee was directed to pay in case the decedent's sister should, by reason of accident, illness, or other unusual circumstances, so require, such additional sum or sums as in the judgment of the trustee may be necessary and reasonable under the existing conditions. (R. 16.) At the time of the testator's death, the sister's eyesight was greatly impaired. In 1935 an operation was performed on both her eyes for glaucoma, and in May, 1936, an operation was performed on her right eye for a cataract. (R. 18.) An

examination of her eyes made in August, 1938, showed "Left eye—Hand motion three inches. Right eye approximately eighteen per cent vision." (R. 18–19.)

It would not seem necessary to labor the argument that the trustee might have been obliged to pay additional sums to the testator's sister because of illness, particularly in view of her bad eyesight, and that such payments might have exceeded the difference between the trust income and the $3,000 annuity. Hospital bills, doctors' fees, nurses' salaries, might well amount to $1,800 or $2,200 in the case of a 79 year old woman with bad eyesight. Once the trustee finds it necessary to invade the trust corpus, we step into the field of pure speculation if we try to guess to what extent it will be necessary to invade corpus. Furthermore, illness is not the only contingency upon the happening of which the trustee is directed to make additional payments to the testator's sister. In the case of accident or "other unusual circumstances," the trustee may make such additional payments as in his judgment may be necessary and reasonable. This leaves the door wide open to additional payments so that it would be pure speculation to attempt to value the amount of the residuary bequest to the charities as of the date of the testator's death. Therefore, under the statute and under the Treasury Regulations, the value of the bequest to charities may not be deducted because it is impossible to ascertain the amount as of the date of the testator's death, and it is not severable from the interest in favor of the testator's sister.

A recent decision of the First Circuit, *Gammons* v. *Hassett, supra* p. 230, supports this view. In that case

the decedent died at the age of 92, leaving a widow, aged 93, who had been bedridden for two years at the time of decedent's death. Under the will the estate was left in trust, the income and "so much of the principal thereof as my said wife may at any time and from time to time *need* or *desire*" (italics supplied), to be paid to his wife during her life. The remainder was left to charitable corporations. At the time of the decedent's death, his property had a value of about $275,000, and his widow's property was worth about $190,000. Over a period of years their combined income had varied between $15,000 and $25,000 a year. They had always lived on a very simple scale and their combined income was in excess of that required to maintain their customary standard of living. The decedent's personal representatives maintained that they were entitled to a deduction of the value of the gift to the charities under Section 303 (a) (3) of the Revenue Act of 1926, which is the same statute that is involved in this case. The Circuit Court affirmed the decision of the District Court which denied the deduction on the ground that the value of the charitable remainders could not be determined at the date of the decedent's death. The court said in its opinion (pp. 232, 233):

> As to the plaintiffs' last contention, we agree that the likelihood of the use of the power was extremely remote at the time of the testator's death, but this fact does not bring the case within the principle of *Ithaca Trust Co.* v. *United States, supra,* and *United States* v. *Provident Trust Co., supra.* In both of those cases the

> value of the charitable gifts was certain with a quality of certainty not present in this case.
>
> * * * * *
>
> We know of no standard fixed in fact by which we could measure either the extent of the life tenant's desires or the likelihood of an exercise of those desires, so that we could place a definite value on the charitable bequests. While we grant that the likelihood of invasion of the principal was extremely remote at the testator's death, still the possibility of invasion did exist and, therefore, the amount of the property which would go to charity was uncertain.

In the instant case, as in *Gammons* v. *Hassett, supra,* the likelihood of the invasion of the corpus was remote. But cases of this type must be governed by the existence of the power rather than the likelihood of its use, as shown by the extrinsic circumstances, varying, of course, in each particular case. See concurring opinion of Judge Magruder in *Gammons* v. *Hassett,* at pp. 234–235.

In *Knoernschild* v. *Commissioner,* 97 F. 2d 213 (C. C. A. 7th), the testator left property to his daughter in trust, with the property to go to charity on the daughter's death. It was provided that the daughter could invade the principal for the purpose of providing financial assistance for her mother or any of her brothers or sisters. The court refused to allow a deduction on account of the charitable bequest. In its opinion the court said (pp. 214–215):

> There is no limitation upon the discretion thus granted to the daughter to divert the income, principal, or both, from charitable purposes to uses entirely private in character, except that

> the diversion must provide "financial assistance." The term is a broad one. It might include a vast sum to retire a mortgage bond issue in default, in order to prevent foreclosure. It might include substantial sums to one or more beneficiaries who had become financially involved, for the purpose of preventing bankruptcy. It would include any untold number of possible necessities for financial aid such as loss by speculation, gambling, unwise investment, loss by fire and water or other elements. In other words, the right extended to her to divert any or all of the funds to the financial aid of a number of other persons is so wide and so broad as to make possible the entire destruction of the corpus of the estate passing to the Academy.

In *Pennsylvania Co. for Insurances, Etc.* v. *Brown,* 6 F. Supp. 582 (E. D. Pa.), affirmed *per curiam,* 70 F. 2d 269 (C. C. A. 3d), the residuary estate was left in trust (1) to pay certain life annuities to designated beneficiaries; (2) to pay $5,000 each to surviving daughters of four nephews and nieces; and (3) upon the termination of all the foregoing trusts to pay over the remainder to designated charities. At the date of death, there were five living daughters, and the two nephews, 45 and 51 years of age, respectively, were both married. The court there recognized that the chances were slender that any more daughters would be born to reduce the bequests to the charities but concluded that the amount was not definitely ascertainable and denied the deduction. The court made this pertinent observation (pp. 583–584):

> Of couse, in this particular case any one could make a pretty good guess at it, but, if there were

> twenty nephews and nieces, all young and all married, the situation would be very different. If that were the case, the charitable bequest might easily be cut in half or more when the time for distribution arrived.

See also *Humes* v. *United States, supra,* in which the Court said (p. 494):

> One may guess, or gamble on, or even insure against, any future event. * * * But the fundamental question in the case at bar, is not whether this contingent interest can be insured against or its value guessed at, but what construction shall be given to a statute. Did Congress in providing for the determination of the net estate taxable, intend that a deduction should be made for a contingency, the actual value of which cannot be determined from any known data? Neither taxpayer, nor revenue officer—even if equipped with all the aid which the actuarial art can supply—could do more than guess at the value of this contingency. It is clear that Congress did not intend that a deduction should be made for a contingent gift of that character.

The instant case is analogous to cases arising under Section 162 (a) of the Revenue Act, which allows as a deduction from the gross income of a trust amounts paid or permanently set aside for charitable purposes. In *Bank of America Nat. T. & S. Ass'n.* v. *Commissioner,* 126 F. 2d 48, decided by this Court in February, 1942, the question was whether certain capital gains were permanently set aside for charitable purposes, where private gifts of the trust income and annuities

were to be paid before the charities took the remainder of the income. This Court decided that the taxpayer failed to maintain the burden of proving the amount of the capital gains, if any, that were permanently set aside for charitable purposes. See also *Guaranty Trust Co. of New York* v. *Commissioner,* 31 B. T. A. 19, affirmed *per curiam,* 76 F. 2d 1010 (C. C. A. 2d), certiorari denied, 296 U. S. 591; *Boston Safe Deposit & T. Co.* v. *Commissioner,* 66 F. 2d 179 (C. C. A. 1st), certiorari denied, 290 U. S. 700; *Charles P. Moorman Home for Women* v. *United States,* 42 F. 2d 257 (W. D. Ky.).

In cases arising under Sections 166 and 167 of the Revenue Act, where the income of trusts is taxed to the grantor even though it is not actually paid to him, the courts have laid down the test of the existence of the power to get control of the trust income or corpus, instead of relying upon the actual use of the power. See *Helvering* v. *Stuart,* decided by the Supreme Court on November 16, 1942 (1942 C. C. H., par. 9750); *Altmaier* v. *Commissioner,* 116 F. 2d 162, 165 (C. C. A. 6th), certiorari denied, 312 U. S. 706; *Kaplan* v. *Commissioner,* 66 F. 2d 401, 402 (C. C. A. 1st); *Rollins* v. *Helvering,* 92 F. 2d 390, 395 (C. C. A. 8th); *Esty* v. *United States,* 63 C. Cls. 455, 462–463; *Helvering* v. *Evans,* 126 F. 2d 270, 272–273 (C. C. A. 3d), certiorari denied, October 12, 1942.

The Board of Tax Appeals decided this case on the authority of its decision in *Field* v. *Commissioner,* 45 B. T. A. 270, which is now pending on appeal to the Circuit Court of Appeals for the First Circuit, *sub.*

nom. Commissioner v. *Merchants Nat. Bank,* which was argued on December 1, 1942, and has not yet been decided. The decision of the Board of Tax Appeals in the *Field* case (in which four members dissented) relies strongly upon the decision of the Supreme Court in *Ithaca Trust Co.* v. *United States, supra.* In the *Ithaca Trust* case (p. 154) the testator gave the residue of his estate to his wife for life with authority to use from the principal any sum "that may be necessary to suitably maintain her in as much comfort as she now enjoys." After the death of the wife there were bequests in trust for charities. The Supreme Court held that the value of the charitable remainder was ascertainable at the date of the testator's death and, hence, deductible from the gross estate. In that case the Supreme Court said (p. 154):

> The principal that could be used was only so much as might be necessary to continue the comfort then enjoyed. The standard was fixed in fact and capable of being stated in definite terms of money. It was not left to the widow's discretion.

It was certain that the charities would take the property over and above what was required to maintain the life tenant's customary standard of living. That amount of property and its value could be determined definitely. In the instant case we have no such certainty. The estate is first subject to an annuity to be paid at the rate of $250 per month for the rest of the annuitant's life, and then to such additional payments as the trustee might make to the annuitant on account of "accident, illness, or other unusual circumstance."

There is no standard fixed in fact by which we can measure the amounts that will be paid on account of accident, illness, or other unusual circumstances. The Board found as a fact that the annuitant's vision was greatly impaired; that there was only 18 percent vision in one eye and hand motion was visible at only three inches in the other; that both eyes had been operated for glaucoma, and one eye for a cataract. (R. 18–19.) Therefore, there was a distinct possibility that substantial sums might have to be spent on account of doctors' and nurses' fees and hospital expenses. This case differs materially on its facts from the *Ithaca Trust Co.* case.

In its opinion in the instant case the Board said that "it seems highly improbable that 'accident, illness or other unusual circumstances' would necessitate the trustee delving into corpus or even surplus income." (R. 21.) But as both the majority and the concurring opinions in *Gammons* v. *Hassett, supra,* point out, the test to be applied in cases of this sort is the *existence* of the power or the *possibility* of invasion of the corpus, not the likelihood of its exercise.

There is a decision of the Tenth Circuit to the contrary, *Commissioner* v. *F. G. Bonfils Trust,* 115 F. 2d 788. In that case, which arose under Section 162 of the Revenue Act of 1934, the majority held that the evidence established beyond a reasonable doubt that there never will be any recourse to the corpus to pay annuities, and that the corpus was, in fact, permanently set aside in the taxable years for charitable purposes. Judge Bratton, who dissented, thought that under the

statute it was immaterial that during the taxable years the corpus was not likely to be invaded. He said (p. 794):

> Up to the present the ordinary, annual income of the trust estate has far more than sufficed to pay the current annuities, and it seems reasonably certain that it will continue to do so in the future. Still, it cannot be foretold with absolute certainty that such condition will always exist to the death of the last survivor of the annuitants.

If this Court should decide to follow the majority opinion in the *Bonfils* case, it may be pointed out that the facts of the two cases differ substantially and that the likelihood of invasion of the corpus is much greater under the circumstances of this case than in the *Bonfils* case. In the latter case the trust income was about five times the amount required for the annuities during the years after testator's death; in this case, they were less than double the amount of the annuity, regardless of other charges, and in several years they were less than 35 percent in excess of the annuity. Moreover, here the corpus could be invaded for purposes other than the payment of the annuity.

This Court will undoubtedly recognize that if the Government prevails on this appeal, the amount of the charitable gifts will be reduced accordingly. Therefore, the Board's opinion makes a strong appeal to construe the statute in a manner that will aid the charities. But it is not Congress that deprived the charities of part of a bequest, it is the testator. If he cuts all the strings

attached to the gift of the remainder, the charities get the remainder free of any charge for estate taxes. But if he makes the gift over contingent upon the non-exercise by the trustee of such broad powers as we have here, it does not seem unfair to deny the deduction. In this connection Judge Magruder said in his concurring opinion in *Gammons* v. *Hassett, supra,* p. 235:

> The testator can save estate taxes by giving an indefeasible remainder to charity upon death of the life tenant. But if he chooses to make the gift over contingent upon the non-exercise by the life tenant of such a broad power as here conferred, it does not seem unfair to deny the deduction. The *Ithaca Trust* case must be considered as going to the very verge of the law, and in the absence of further guidance from the Supreme Court we ought not to extend the doctrine of that case, however logical and appealing the extension might be under the particular facts.

We do not press the argument made before the Board of Tax Appeals that only a portion of the charitable bequests should, in any event, be deductible, that is, not to exceed one-third of the net estate plus the value of the bequests to the California State Library and the Sonoma County Social Service Department, within the meaning of Sections 41 and 42 of the California Probate Code (Appendix, *infra*). The decision of this Court in *Mead* v. *Welch,* 95 F. 2d 617, 619, would seem to preclude the soundness of that argument in this jurisdiction.

CONCLUSION

The decision of the Board of Tax Appeals is wrong and should, therefore, be reversed.

Respectfully sumbitted,

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JANUARY 1943

APPENDIX

Revenue Act of 1926, c. 27, 44 Stat. 9:

> SEC. 303 [as amended by Sec. 403 (a) of the Revenue Act of 1934, c. 277, 48 Stat. 680]. For the purpose of the tax the value of the net estate shall be determined—
>
> (a) In the case of a citizen or resident of the United States by deducting from the value of the gross estate—
>
> * * * * *
>
> (3) The amount of all bequests, legacies, devises, or transfers, to or for the use of the United States, any State, Territory, any political subdivision thereof, or the District of Columbia, for exclusively public purposes, or to or for the use of any corporation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, * * *.
>
> * * * * *

Probate Code of California[1] (Deering, 1931):

> * * * * *
>
> § 41. *Restrictions.* No estate, real or personal, may be bequeathed or devised to any charitable or benevolent society or corporation, or to any person or persons in trust for charitable uses, unless done by will duly executed at least thirty days before the death of the testator. If so made at least thirty days before death, such devises and legacies shall be valid, but they may not collectively exceed one-third of the estate of

[1] Sections 41 and 42 of the California Probate Code were amended, effective August 27, 1937, the day *after* decedent died. The sections as quoted above are the sections as in effect on the date decedent died.

a testator who leaves legal heirs, and if they do, a pro rata deduction from such devises and legacies shall be made so as to reduce the aggregate thereof to one-third of the estate. All dispositions of property made contrary hereto shall be void, and go to the residuary legatees or devisees or heirs, according to law.

§ 42. *Exemption of certain donees from restrictions.* Bequests and devises to or for the use or benefit of the state, or any municipality, county or political subdivision within the state, or any institution belonging to the state, or belonging to any municipality, county or political subdivision within the state, or to any educational institution which is exempt from taxation under section 1a of article XIII or section 10 of article IX of the constitution of this state and statutes enacted thereunder, or for the use or benefit of any such educational institution, are excepted from the restrictions of this article.

Treasury Regulations 80 (1937 Ed.):

ART. 44. *Transfers for public, charitable, religious, etc., uses.*—* * *

If a trust is created for both a charitable and a private purpose, deduction may be taken of the value of the beneficial interest in favor of the former only insofar as such interest is presently ascertainable, and hence severable from the interest in favor of the private use. * * *

* * * * *

ART. 47. *Conditional bequests.*—If the transfer is dependent upon the performance of some act or the happening of some event in order to become effective, it is necessary that the performance of the act or the occurrence of the event shall have taken place before the deduction can be allowed.

If the legatee, devisee, donee, or trustee is empowered to divert the property or fund, in whole or in part, to a use or purpose which would have

rendered it, to the extent that it is subject to such power, not deductible had it been directly so bequeathed, devised, or given by the decedent, deduction will be limited to that portion, if any, of the property or fund which is exempt from an exercise of such power.

The provisions of Articles 44 and 47 of Treasury Regulations 80 (1934 Ed.) are identical with the above quoted provisions.

U. S. GOVERNMENT PRINTING OFFICE: 1942

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No. 10,213

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION, as Executor of the Last Will and Testament of ELISHA COBB MAYO, Deceased,
Respondent.

BRIEF FOR RESPONDENT.

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BRIEF FOR RESPONDENT.

OPINION BELOW.

The only previous opinion in this case is that of the United States Board of Tax Appeals (R. 14-25) which is a memorandum opinion and, therefore, not officially reported.

JURISDICTION.

This petition for review (R. 26-29) involves estate tax in the amount of $5,971.61 and is taken from a decision of the Board of Tax Appeals that there was no deficiency, entered December 30, 1941 (R. 25-26). The case is brought to this Court on a petition for

review filed by the Commissioner of Internal Revenue on March 14, 1942 (R. 26-29) pursuant to the provisions of Sections 1141-1142 of the Internal Revenue Code.

QUESTION PRESENTED.

Whether testamentary gifts to admitted charities in remainder after an intervening $250 a month annuity chargeable against income for the life of decedent's aged sister are so uncertain as to not be allowable as a deduction of the value of the remainder interest to the charities from the gross estate under Section 303 (a) (3) of the Revenue Act of 1926, as amended.

One may note there was an alternative question presented to the Board, but respondent assumes for the purposes of this brief that petitioner on appeal has, by his slight reference to *Mead v. Welch,* 95 F. (2d) 617 (Opening Brief, p. 23) abandoned it. Regard, also, for legislative policy and intent, Section 408 (a), Revenue Act of 1942 amending Section 812 (d), Internal Revenue Code relating to the deduction for charitable bequests (Section 303 (a) (3)) here at issue.

STATUTES AND REGULATIONS INVOLVED.

The statutes and regulations involved may be found in the Appendix, *infra,* pp. i-ii.

STATEMENT.

The facts, some of which were stipulated (R. 33-41) and as found by the Board of Tax Appeals (R. 14-20) are substantially as stated by Petitioner in his Opening Brief (pp. 3-8).

It would seem appropriate on brief, rather than on oral argument, inasmuch as the transcript of the proceedings before the Board are not in the Record on Appeal, to indicate that counsel for the parties stipulated (Board Transcript p. 18) in the event a computation under Board Rule 50 became necessary to ascertain the extent of the remainder interest going to the charities the applicable Treasury Regulations might be used (Reg. 80, Art. X). The Board found on the factual record the entire remainder interest was deductible, hence there was no need to point to this stipulation. Although no such issue is contemplated before this Court, one should observe that an amount much less than the entire remainder to the charities which would be definitely deductible under Section 303 (a) (3) of the Revenue Act of 1926, as amended, would still produce no estate tax. Therefore, out of an abundance of caution, respondent wishes to save the point.

As previously stated, Petitioner has substantially set forth the facts (Opening Brief pp. 3-8) in the case. However, one other compelling factual instance drew the attention of Judge Kern in regard to the mode of living of the sole annuitant of part of the income and the possibility of exercise of the power in the Trustee to disburse surplus income or corpus. The witness, Trust Officer administering the trust, was

asked on direct examination what, from his personal knowledge, Miss Rebecca Mayo's habits of life were:

"A. She lives alone in a little house which her brother gave to her. She lives with a housekeeper. Because of her impaired vision she never goes out, perhaps, once or twice a month to the bank or some place else to vote, or something of that kind. She lives very economically. She spent her whole life as a school teacher. Her only recreation is listening to a so-called talking-book machine and to the radio. She has no automobile.

Q. Does she go out on the streets alone?

A. Not now; not during the past year she has not.

The Member. What is a talking-book machine?

The Witness. They are records made at the Library of Congress in which a person reads a book into a recording machine transcribed on records, and then a person can play the record and then hear the book.

The Member. Oh, I see." (Board Tr. pp. 22-23.)

And later, after the same witness had testified no payments were made from the corpus of the trust or payments from income under the extraordinary power given the Trustee, except:

"Q. This talking-book machine was it purchased from the trust?

A. Yes, it was. It was purchased from the income account.

Q. And in addition to the $250 a month payments?

A. Yes. She was very reluctant to try it until we bought it ourselves from the trust.

Q. How much did that cost?

A. As I remember it, it was $65." (Board Tr. p. 25.)

SUMMARY OF ARGUMENT.

When the dominant facts in this case are brought to focus with the pertinent limitations in the Will of Elisha Cobb Mayo, the conclusion is convincing that here is a case in which an independent Trustee is more restricted in his powers of exercise in favor of the sole beneficiary of only part of the income of the trust than appeared in *Ithaca Trust Co. v. United States,* 279 U. S. 151. If this contention be at all tenable the cases upon which the Appellant must mainly rely are not apt as they are clearly distinguishable. *Gammons v. Hassett,* 121 F. (2d) 229 (C. C. A. 1st), certiorari denied, 314 U. S. 673, and *Field v. Commissioner,* 45 B.T.A. 270, reversed C.C.A. 1, *sub. nom. Commissioner v. Merchants National Bank of Boston, Executor,* December 30, 1942 (copies of opinion to counsel and Court about January 7, 1943).

Authorities which deal with an income tax statute on facts and limitations in living trust instruments which reserve to the grantor-beneficiary broad powers of control would seem to be irrelevant.

ARGUMENT.

SECTION 303 (a) (3) OF THE REVENUE ACT OF 1926, AS AMENDED, ALLOWS AS A DEDUCTION FROM THE GROSS ESTATE THE VALUE OF CHARITABLE REMAINDER INTERESTS AFTER AN INTERVENING LIFE ESTATE OR AN ANNUITY PAYABLE OUT OF INCOME MORE THAN SUFFICIENT TO PAY SUCH ANNUITY, AND WHERE THE TRUSTEE IS AUTHORIZED TO MAKE PAYMENTS FROM SURPLUS INCOME AND THEREAFTER FROM PRINCIPAL TO THE LIFE TENANT OR INCOME BENEFICIARY ONLY WHERE NECESSARY AND REASONABLE UNDER NECESSARY, UNUSUAL AND EXTRAORDINARY CIRCUMSTANCES SUCH AS ACCIDENTS OR ILLNESS.

The dominant facts are: There was one annuitant. Only part of the income was used to satisfy the sole obligation standing between the charitable remainders. When the testator died his sister, the annuitant, was, on that date about 79 years of age. She was virtually blind and beyond operative surgery or dietary treatment. Her life expectancy was short. Her habits of life were simple. She was frugal. One must be imaginative indeed to conceive a situation in her life thereafter which would "require" or find "necessary" the use of surplus income, much less the corpus. Rebecca S. Mayo died November 3, 1942. (Samuel O. Clark, Jr., Assistant Attorney General was so notified by this counsel, letter dated November 5, 1942.) The limitation upon the independent Trustee in the Will was as follows:

> "From the said trust property my aforesaid trustee shall pay the sum of Two Hundred Fifty ($250.00) dollars per month to my sister Rebecca S. Mayo, said payments to run from the date of my death, and in case she should, by reason of accident, illness, or other unusual circumstances

> so require, such additional sum or sums as in the judgment of said trustee may be necessary and reasonable under the existing conditions." (R. 16.)

The familiar test of deductibility was voiced by Mr. Justice Holmes in the *Ithaca Trust Co.* case, *supra,* at p. 154:

> "* * * The principal that could be used was only so much as might be necessary to continue the comfort then enjoyed. The standard was fixed in fact and capable of being stated in definite terms of money. It was not left to the widow's discretion. The income of the estate at the death of the testator and even after debts and specific legacies had been paid was more than sufficient to maintain the widow as required. There was no uncertainty appreciably greater than the general uncertainty that attends human affairs."

It should be remembered that this reasoning of Mr. Justice Holmes was applied to a case where the testator gave the residue of his estate to his wife for life with authority to use from the principal any sum "that may be necessary to suitably maintain her in as much comfort as she now enjoys." There the widow was entitled to *all the income,* whereas, Miss Mayo was entitled to an annuity amounting to less than the actual income. The widow was to be maintained in "comfort". Miss Mayo had call upon the Trustee only for necessaries and extraordinary demands. "Comfort" is a subjective and expansive term, giving much latitude in the possibility of exercise of the power thereunder. Miss Mayo must objectively convince an

independent Trustee that her "* * * accident, illness, or other unusual circumstances so require(d)" and in the judgment of the Trustee found to be "* * * necessary and reasonable under the existing conditions." The Appellant in his Opening Brief, p. 2, under his "Question Presented" rather overstates his case when he says: "* * * despite the trustee's *unrestricted power* to invade the trust corpus * * *." (Emphasis supplied.) Again, in his "Index" p. (1), and at p. 10, under "Argument" he contends the amounts which go to charities are not ascertainable "* * * because of the trustee's *unrestricted* power to invade the corpus * * *". (Emphasis supplied.) A reader of Appellant's Brief may be, at outset, thrown off balance. Composed and tight thinking finds loose use of words disconcerting. If reference be needed on the restricted powers of the Mayo Trustee, see

Restatement of the Law of Trusts, Sections 128, 154, 157; and

Scott on Trusts, same sections, as expanded; also,

Civil Code of the State of California, Sections 863 and 2269;

Estate of Smith (1937), 23 Cal. App. (2d) 383, 73 P. (2d) 239;

Hartford-Connecticut Trust Co. v. Eaton (C.C. A. 2, 1929), 36 F. (2d) 710 (second hearing 1934, 8 F. Supp. 218).

Respondent has emphasized the strength of the instant case in relation to the *Ithaca Trust Co.* case, *supra,* to throw the Mayo facts and limitations of the

Will on the Trustee so that *Gammons v. Hassett, supra,* and *Field v. Commissioner, sub nom.* C.C.A. 1, *Commissioner v. Merchants National Bank of Boston, Executor, supra,* may be considered in proper relief.

Respondent contends that when the smoke of Appellant's other citations is cleared, reliance is placed upon the *Gammons* and *Field* cases. Justice Mahoney spoke for the majority of the First Circuit in both cases.

In the *Gammons* case the power to invade corpus was limited to "so much of the principal thereof *as my wife* may at *any* time and from time to time need or *desire,* to be paid to my said wife during her life." The taxpayer failed because of the disjunctive use of the word "desire". The majority said (at p. 231): "When the testator *gave his wife the power* to invade the principal *as she 'may * * * desire,'* he meant what he said. He intended to give her a broad power of invasion of the principal *not restricted* to a mere use of the corpus for the purpose of satisfying her needs." (Emphasis supplied.)

The Ithaca Trust Co. case was distinguished (at p. 233) in that: "It was not left to the widow's discretion." And the fifth sentence farther on in the opinion: "We know of no standard fixed in fact by which we could measure either the extent of the life tenant's desires or the likelihood of an exercise of those desires so that we could place a definite value on the charitable bequests." The Court was there comparing the *Ithaca Trust Co.* case with the case then at bar. Recall the word "comfort" was receiving construction

by Mr. Justice Holmes in the *Ithaca Trust Co.* case! It takes no herculean feat of the mind to mark the difference of the pertinent phrases in the *Mayo Will.*

The expansive and subjective qualities of the terms "comfort" and "desire" may convincingly be indicated in considering the *Field* case. Mark the contrast of the predominantly objective qualities of the term "needs" or an even more definite term "emergencies" or the phrase "illness, accident, or other unusual circumstances". The point is: The word "needs" correlates with "maintenance and support" cases. But "illness, accident, or other unusual circumstances" goes beyond and further limits the discretion or the existence of the power in the Trustee.

The First Circuit Court's decision in *Field v. Commissioner, supra,* would appear to pinion the case for the Appellant. Born of an early educational dislike for "paste and shears" briefs, the writer is none-theless impelled to quote extensively that Court's opinion: First, the limitation (p. 2): "* * * for the comfort, support, maintenance, *and/or happiness* of my said wife, * * * said Trustee shall exercise its discretion with *liberality to my said wife,* and consider her welfare, *comfort and happiness prior* to claims of residuary beneficiaries under this trust". (Emphasis supplied.) "Happiness" is the new word to receive construction. And with further unqualified "liberality". Note also "support" and "maintenance" are deleted from the phrase dealing with "liberality". Justice Mahoney reasons (pp. 5-7):

"* * * The decision in the instant case depends upon the proper interpretation of the language used in the testamentary trust, that is, whether or not there is present a possibility of invading the corpus of the trust in the sense that that phrase was used in *Gammons v. Hassett, supra.* The intention of the testator is to be found in the four corners of the will. His *language is to be literally interpreted* unless there is some ambiguity as to its meaning. Here the *testator clearly* stated that he sought to provide for the comfort, support, maintenance and/or *happiness* of his wife. It is, of course, true that it is difficult to define precisely what happiness means, but *happiness is essentially a subjective matter and must be left to an honest determination of the widow. The testator used both the conjunctive and disjunctive* showing clearly that he did not want the term 'happiness' to be considered as a catch-all. *It would be torturing the language used if we were to treat the word happiness as a mere superfluity.* If the widow should *desire* to provide permanently for the adopted children or for near relatives such a *desire* would be within the term 'happiness'. There is thus the *clear possibility (or probability)* that the corpus of the trust may be invaded.

"We recognize, as the respondent urges upon us, that there exist certain distinctions in the case before us and *Gammons v. Hassett, supra.* In that case the term *'desire'* was used, which may be said to be *somewhat broader than the term 'happiness'. There,* an invasion of the corpus of the trust *depended completely upon the will of the widow.* Here, there can only be an invasion of the corpus of the trust if in the sole discretion and wisdom of the trustee an invasion of the principal is

deemed necessary for the happiness of the widow. *But this can mean no more than that the widow must convince the trustee that* an invasion of the *corpus is necessary to her happiness. The testator,* out of abundant caution, in order to prevent any disagreement, *admonished the trustee to exercise its discretion with liberality.* Assuming then that she is able to convince the trustee that her happiness requires the expenditure of sums of money beyond the income and out of the corpus of the trust, the amount that would ultimately go to charity would *be uncertain. Since this possibility exists within the language of the trust instrument,* the case is *closer* to our decision in *Gammons v. Hassett, supra,* than it is to the *Ithaca Trust* case. The argument that under the facts in this case there is little likelihood that Mrs. Field will want to invade the corpus of the trust is similar to the argument advanced in *Gammons v. Hassett,* supra. We refused in that case to consider extrinsic evidence of a most persuasive nature. The widow was ninety-three years old, had been bedridden for years and had ample property of her own for her support. We said: 'While we grant that the likelihood of invasion of the principal was extremely remote at the testator's death, still the possibility of invasion did exist and, therefore, the amount of the property which would go to charity was uncertain'. (p. 233.)

"The respondent cites *First National Bank of Birmingham v. Snead,* 24 F. (2d) 186 (C.C.A. (5th) 1928); *Hartford-Connecticut Trust Co. v. Eaton,* 36 F. (2d) 710 (C.C.A. (2d) 1929); *Lucas v. Mercantile Trust Co.,* 43 F. (2d) 39 (C.C.A. (8th) 1930), and *Commissioner v. F. G. Bonfils*

> *Trust, supra,* as supporting its position. *These cases are clearly distinguishable.* The first three deal with *support and maintenance of the widow and clearly fall within the rule laid down* in the *Ithaca Trust* case. *The position which we take in the instant case is not at all inconsistent with those holdings.* * * *'' (Emphasis supplied.)

Can there be any doubt as to how the First Circuit would rule in the *Mayo* case? One is not unmindful of the words of Justice Magruder in his concurring opinion in *Gammons v. Hassett, supra,* p. 235: "But if he (testator) chooses to make the gift over contingent upon the non-exercise by the life tenant *of such a broad power* ('desire') as here conferred, *it does not seem unfair* to deny the deduction. The *Ithaca Trust* case must be considered as going to the *very verge* of the law, * * *''. Contrast the foregoing with how this concurring opinion starts out: "In my opinion the case at bar could be decided in favor of the taxpayer on a perfectly logical application—or perhaps extension—of the principle laid down in *Ithaca Trust Co. v. United States* (citation)''. One who sat at the feet of Justice Magruder in his professorial days may well wonder how much of an honestly intellectual, rather than a legalistic, nudge would have been necessary to cast him over the "verge" into a dissent in the *Gammons* case!

An interesting footnote to the *Field* decision is that Judge Kern, who wrote the opinion in the instant case (R. 20-26) was one of the four dissenters whose views were approved by the reversal against the tax-

payer in First Circuit. In a masterly piece of understatement Judge Kern said (R. 20): "If there is any material difference between the ultimate material facts in that (*Field*) case and the present proceedings it would seem to be in the present petitioner's favor". Again, (R. 21): "In the instant proceedings the trustee is *strictly limited* to a situation where 'by reason of accident, illness, or other unusual circumstances' the life beneficiary should 'require' sums in addition to the payment of $250 per month. The income from the trust corpus could reasonably be expected to provide sufficient cash for the $250 monthly payments to decedent's sister. During the years of the trust's existence the income thereof has been considerably in excess of the amounts necessary to make these payments. And, since decedent's sister has to date saved the greater part of her annuity payments, it seems *highly improbable* that 'accident, illness or other unusual circumstances' would *necessitate* the trustee delving into corpus *or even surplus income*". This was the reasoning of the Judge who found the facts.

Unless this Court can say as a matter of law the Board's conclusion from the facts found are clearly erroneous, its determination should stand. *California Barrel Co. Inc. v. Commissioner* (C.C.A. 9, 1936), 81 F. (2d) 190.

On the particular facts in this case and the appropriate decisions under the applicable estate tax law, counsel for taxpayer harkens to ever so faint a whisper of admonition from the epigrammatic father of the

present majority on the United States Supreme Court, Mr. Justice Holmes, in *Corliss v. Bowers,* 281 U. S. 376 at 378: "* * * taxation is not so much concerned with the refinements of title as it is with the actual command over the property taxed—the actual benefit for which the tax is paid". In the multiplicity of legalistic tax opinions of the years between, one may ponder how complete the reversal by Holmes' pupils of his juristic philosophy when they heed the promptings of government counsel in decisions which stem from arguments directed at "refinements of title". In this vein, renewed and wholesome respect for the sound and practical good sense of another member of the old court is engendered in reading again an opinion bottomed on human fact, not professorial fancy. See, Mr. Justice Sutherland in *United States v. Provident Trust Co.,* 291 U. S. 272. Compare, *Helvering v. Hallock,* 309 U. S. 106; *Helvering v. Horst,* 311 U. S. 112; *The State Tax Commissioner of Utah v. Aldrich,* 316 U. S. 174. As one capable lawyer, in a moment of kindly levity, said: "After the *Horst* case, anything can happen". And, in *Utah v. Aldrich* even that pleasing plugger of the loopholes of 1937 could not stomach the philosophy or reasoning of the majority, so he registered his dissent—Mr. Justice Jackson.

To conclude respondent's direct argument on a note of deadly seriousness. In order to sustain appellant on any theory thus far urged, and on germane authority, facts must be found to show Rebecca S. Mayo could draw upon the corpus of this testamentary trust virtually *at will.* It must be further convincingly

shown that there existed *in* Rebecca S. Mayo a power to diminish the principal of the trust estate. Those were the conditions which rendered the amounts of deductions uncertain in the *Gammons* and *Field* cases. Not so here. On brief of this case for Board Member (now Judge) Kern, the writer urged that taxation was a practical matter. There can be no practical question on the facts of the *Mayo* case that these worthy charities, notably the American National Red Cross, will take the full remainder of this estate upon the death of Rebecca S. Mayo. It would be a travesty not only on common sense, but of the decisional and legislative law, to hold that on the date of decedent's death in August of 1937 there was any "* * * uncertainty appreciably greater than the general uncertainty that attends human affairs", that these recognized charities would take their full remainder interest.

Of course, neither the advocate nor Judge would lay claim to clairvoyance, but today we know the charities do take their full remainder interests (plus accumulation of income not appropriated to the payment of the $3000 annuity). Was it any less certain on these facts on the date of Elisha Cobb Mayo's death?

ANSWER TO APPELLANT'S ARGUMENT.

In the round, cases classify on the issue in this case into:

Conditions precedent: *Burdick v. Commissioner,* 117 Fed. (2d) 972, certiorari denied 314 U. S. 641 (there,

charities would take only upon the action of a sister and nephew under a power which they were free to exercise or not).

Contingent: *Humes v. United States,* 276 U. S. 487 (the charity would take only if "this Texas girl of fifteen will not marry, or if she does, will die without issue before age of thirty or thirty-five, or forty"); *Helvering v. The Union Trust Company, etc.* (*Estate of Carolyn G. Caughey*), 125 Fed. (2d) 401, certiorari denied 62 S. Ct. 1292 (where the remainder interests were to pass to a non-charitable organization should the Girl Scouts fail to use the other real estate in the manner directed); *Pennsylvania Co. for Insurances, Etc. v. Brown,* 6 F. Supp. 582, affirmed *per curiam,* 70 F. (2d) 269.

Diversion by the beneficiary: *Knoernschild v. Commissioner,* 97 F. (2d) 213 (daughter given the right to direct the trustee to pay any part of the fund as her judgment saw fit to mother or any of her brothers or sisters in case they were in need of "financial assistance". The Court observed the quoted phrase was broad enough to "include a vast sum to retire a mortgage bond issue upon which there was a default to prevent foreclosure". Even embrace "financial aid such as loss by speculation, gambling, unwise investment, etc.").

"Desire" or "happiness" of beneficiary: *Gammons* and *Field* cases, *supra.*

"Needs" or "maintenance and support" of life tenant or beneficiary: *Ithaca Trust Co. v. United*

States, supra; First National Bank of Birmingham v. Snead, 24 F. (2d) 186; *Lucas v. Mercantile Trust Co.,* 43 F. (2d) 39; *Millard v. Humphrey,* 79 F. (2d) 107.

Emergencies or "accident, illness, or other unusual circumstances": *The Estate of Elisha Cobb Mayo,* at bar.

The foregoing classification of cases and their separate categories are recognized by courts as being quite distinct on their facts and for purposes of decision under Section 303 (a) (3) of the Revenue Act of 1926, as amended.

It would seem to properly follow that respondent in answer to argument of appellant should touch but lightly on the vaguely analogous cases arising under the unrelated income tax statutes dealing with broad powers reserved in a settlor-beneficiary, sometimes denominated "controlled trusts". See, *Jacob Mertens, Jr., The Law of Federal Income Taxation* (December 1942), Chapters 36 and 37 at Sections 36.68 and 37.03, *et seq.* Appellant's discussion of cases dealing with the "existence of the power (in the beneficiary) rather than the likelihood of its use" are completely off the point. No power existed in Miss Mayo and the power which existed in the Trustee was more restricted in scope than any case which, it would seem, has thus far reached the Courts. Even income tax cases, which we contend is very wide of fitting analogy to the case at bar, assist the construction which respondent here urges. See, reasoning of the Court in *Commissioner v. F. G. Bonfils Trust,* 115 F. (2d) 788.

Coming directly to the opening brief of appellant, it may be said that of the twenty-one cases cited, twelve are income tax cases to considerable extent irrelevant. Of the remaining nine cases dealing with estate tax and the applicable statute before us, only three of them are even close. Of those three the *Gammons* and *Field* cases, supra, involved the construction of subjective terms depending almost wholly upon the personal feelings, or perhaps caprice, of the beneficiary. The decision in *Ithaca Trust Co. v. United States, supra,* may fairly be said to relate largely to maintenance and support cases. We think and contend that maintenance and support provisions have more facets of a subjective character and implications less objective than the terms of the phrase here under construction "accident, illness, or other unusual circumstances".

But, at very outset and thereafter with profusion, appellant uses inept expressions, a few of which follow: "trustee's unrestricted power" (App. Op. Brief, pp. (1), 2); "* * * it could not be said with *absolute assurance* * * *" (p. 9); "* * * one could (not) *predict* that the corpus would *never be invaded*" (p. 9); "the trustee *might* invade the corpus" (p. 12); "it could not be said with absolute assurance * * *" (p. 13); "the trustee *might* have been obliged" (p. 14); "This leaves the *door wide open* to additional payments so that it would be *pure speculation* * * *" (p. 14); "there was a *distinct possibility* that substantial sums might have to be spent * * *" (p. 21); "* * * of such *broad powers* as we have here * * *" (p. 23).

Small wonder, when the careful use of words and their meaning is so important, anyone's head may be made, by the foregoing, to spin to a condition of dizziness. On regaining equanimity one may reflect there are no absolutes in the science of the law. Nor, indeed, is there room for extravagant use of language even in the flush of advocacy.

In all fairness to our opponent we do perceive the artificial heart of his case amid the confusion of words. At page 16, he says: "But cases of this type must be governed by the existence of the power rather than the likelihood of its use, as shown by extrinsic circumstances, varying, of course, in each particular case". The vice of this proposition, assuming, *arguendo,* the test itself were sound, is twofold: First, the existence of the power *does* vary under the facts of each case. The limitation in the trust instrument is but one fact or circumstance to be considered. Second, no such power existed in Rebecca S. Mayo.

Again, at page 21, petitioner states: "* * * the test to be applied in cases of this sort is the *existence* of the power or the *possibility* of invasion of the corpus, not the likelihood of its exercise". His authority for the statement is predicated on the decision in the *Gammons* case, *supra.* Out of context and the facts of that case this expression has the appearance of vitality. When attempt is made to bring it into balance with the instant case its weight is nil.

In conclusion, beginning on page 18 of petitioner's Opening Brief, he launches upon the purported anal-

ogy of income tax cases. He first quotes *Bank of America National Trust and Savings Association v. Commissioner,* 126 F. (2d) 48, the majority opinion having been written by Mr. Justice Denman of this Court. Anything this brief writer might say toward pointing the obvious distinctions between the case now before the Court and the cited case, would seem only to add to the labor of this Court. Of the remaining income tax cases cited by appellant we hazard a similar position.

Likewise, we have not pressed the point of the policy of the tax law and presumptions favorable to charitable deductions, for ample direct authority and more creditable principle is with us.

CONCLUSION.

The decision of the Board of Tax Appeals is right and should, therefore, be affirmed.

Dated, San Francisco,
January 27, 1943.

Respectfully submitted,
EDWARD HALE JULIEN,
Attorney for Respondent.

(Appendix Follows.)

Appendix.

Appendix

Revenue Act of 1926, c. 27, 44 Stat. 9:

SEC. 303 [as amended by Sec. 403 (a) of the Revenue Act of 1934, c. 277, 48 Stat. 680]. For the purpose of the tax the value of the net estate shall be determined—

(a) In the case of a citizen or resident of the United States by deducting from the value of the gross estate—

* * * * * * *

(3) The amount of all bequests, legacies, devises, or transfers, to or for the use of the United States, any State, Territory, any political subdivision thereof, or the District of Columbia, for exclusively public purposes, or to or for the use of any corporation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, * * *.

Treasury Regulations 80 (1937 Ed.):

ART. 44. *Transfers for public, charitable, religious, etc., uses.*—* * *

If a trust is created for both a charitable and a private purpose, deduction may be taken of the value of the beneficial interest in favor of the former only insofar as such interest is presently ascertainable, and hence severable from the interest in favor of the private use. * * *

* * * * * * *

ART. 47. *Conditional bequests.*—If the transfer is dependent upon the performance of some act or the happening of some event in order to become effective, it is necessary that the per-

formance of the act or the occurrence of the event shall have taken place before the deduction can be allowed.

If the legatee, devisee, donee, or trustee is empowered to divert the property or fund, in whole or in part, to a use or purpose which would have rendered it, to the extent that it is subject to such power, not deductible had it been directly so bequeathed, devised, or given by the decedent, deduction will be limited to that portion, if any, of the property or fund which is exempt from an exercise of such power.

The provisions of Articles 44 and 47 of Treasury Regulations 80 (1934 Ed.) are identical with the above quoted provisions.

No. 10214

United States
Circuit Court of Appeals
For the Ninth Circuit.

TODD W. JOHNSON,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

Transcript of Record

Upon Appeal from the District Court of the United States for the Southern District of California, Central Division

ROTARY COLORPRINT, 590 FOLSOM ST., SAN FRANCISCO

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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NAMES AND ADDRESSES OF ATTORNEYS

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Los Angeles, Calif. [1*]

*Page numbering appearing at foot of page of original certified Transcript of Record.

In the District Court of the United Statss in and for the Southern District of California, Central Division.

No. 1195-RJ-Civil

TODD W. JOHNSON,

Plaintiff,

vs.

UNITED STATES OF AMERICA,

Defendant.

COMPLAINT FOR THE RECOVERY OF FEDERAL INCOME TAXES

Comes now the plaintiff and complains of defendant and for his cause of action alleges as follows:

I.

That plaintiff, Todd W. Johnson, is now and at all times mentioned herein was a resident of the County of Los Angeles, State of California, and subject to the jurisdiction of this Court.

II.

Plaintiff is a citizen of the United States of America, has always borne true faith and allegiance thereto, and has never in any way either directly or indirectly aided or abetted anyone in rebellion thereagainst.

III.

The jurisdiction of this Court in the premises is dependent upon a Federal question in that the cause

of action arises under the laws of the United States pertaining to the Internal Revenue.

IV.

On or before March 15, 1936, the plaintiff filed his Federal income tax return for the calendar year 1935, reporting therein net taxable income of $26,541.18 and tax payable thereon of $3,118.95 which he paid to defendant during the calendar year 1936.

V.

Subsequent to March 15, 1936, the Commissioner of Internal Revenue made his audit of plaintiff's said income tax return and erroneously determined that plaintiff was liable for deficiency tax for said year 1935 in the amount of [2] $7,821.89, plus interest of $1,025.84, or a total of $8,847.73.

VI.

Said alleged deficiency tax resulted from the said Commissioner erroneously and illegally determining that plaintiff had a taxable net income of $54,860.13, whereas plaintiff had a correct taxable net income of only $28,074.31.

VII.

Said Commissioner erroneously determined that taxpayer was taxable on all of the following fees received by him during the calendar year 1935, whereas he was only taxable on one-half thereof:

Viber Company legal work	$ 112.00
Roy Tracy Income tax work	55.00
Wm. G. Kerckhoff Estate for legal work	31,791.67
Total	$31,958.67
One-half	$15,979.28

VIII.

Said fees were the community property of Esther Jeanne Johnson and plaintiff, were earned prior to March 4, 1935, were accounts receivable on said date, were collected between March 4, 1935, and December 31, 1935, and only one-half thereof was taxable to plaintiff and the other one-half thereof was taxable to Esther Jeanne Johnson, the then wife of plaintiff.

IX.

Said Commissioner erroneously determined that plaintiff's taxable distributable share of the earnings of Johnson & Johnston, a partnership, as determined by him, was $23,912.41, whereas his correct taxable share of such earnings as determined by said Commissioner, was $13,881.27. The difference of $10,031.14 represents one-half of $20,062.28, which in turn represents the community property interest of said Esther Jeanne Johnson and plaintiff in the collections of Johnson & Johnston from March 4, 1935, to December 31, 1935, all of which were earned prior to March 4, 1935, but were accounts receivable on that date and were collected between March 4, and December 31, 1935. Plaintiff is not taxable upon the community one-half of Esther Jeanne Johnson of said fees.

X.

For more than nine years prior to January 1, 1935, plaintiff and Esther [3] Jeanne Johnson were husband and wife, and during all of said period resided in the County of Los Angeles, State of California. Plaintiff engaged in the practice of law in the City of Los Angeles on July 1, 1929, and continued such practice to May 26, 1933, without any association with any other attorney. On May 26, 1933, plaintiff and one Philip D. Johnston, an attorney at law theretofore employed by plaintiff, entered into a partnership under the firm name of Johnson & Johnston, to engage in the practice of law. This partnership has continued to the present time. In said partnership it was provided that portions of certain fees for work already done by plaintiff on cases in progress should not belong to the partnership, but should belong to plaintiff. The fees set forth in paragraph VII hereof consist of fees which were paid directly to plaintiff under said partnership agreement.

XI.

On March 5, 1935, Esther Jeanne Johnson filed an action in the Superior Court of Los Angeles County, California, against plaintiff praying for a divorce from him. On April 1, 1935, said court entered an interlocutory decree of divorce, and on April 2, 1936, said court entered an final decree of divorce, completely and finally dissolving and severing the bonds of matrimony between her and plaintiff.

XII.

After considerable negotiations between the attorneys for Esther Jeanne Johnson and plaintiff a property settlement agreement was entered into between Esther Jeanne Johnson and plaintiff, a copy of which is attached hereto, marked Exhibit "A," and made a part hereof the same as if set forth in full in words and figures herein.

XIII.

At the same time that said Commissioner erroneously determined that plaintiff owed a deficiency income tax for the calendar year 1935, in the sum of $7,821.89, plus interest of $1,025.84, or a total of $8,-847.73, he also determined that said Esther Jeanne Johnson had made an over-payment of her income tax for the calendar year 1935 in the sum of $3,006.80, which she was entitled to have refunded together with interest of $328.47, or a total of $3,335.27. This over-payment resulted from the erroneous determination by said Commissioner that plaintiff was taxable on all of his earnings, both individually and as a partner in Johnson & Johnston, from March 4, 1935, to December 31, 1935, whereas plaintiff was taxable only on his community one-half thereof. By agreement between Esther Jeanne Johnson, said Commissioner and plaintiff said over-payment and interest thereon was credited against said purported deficiency income tax and interest, and on June 11, 1938, plaintiff paid to defendant the difference of $5,512.56.

XIV.

That plaintiff on April 2, 1940, filed his claim for refund with defendant in the sum of $7,148.11. A true and correct copy thereof is attached hereto, marked Exhibit "B", and made a part hereof by reference. More than six months has elapsed since the filing of said claim and on September 21, 1940, said Commissioner rejected said claim for refund in full. A true and correct copy of his letter rejecting said claim is hereto attached, marked Exhibit "C".

XV.

That as a part of said agreement to credit said overassessment of Esther Jeanne Johnson against said purported deficiency income tax of plaintiff, the said plaintiff agreed with said Commissioner that in the event plaintiff should file a claim for refund or court action for recovery of income tax paid by him for the year 1935 on income held to be his separate property and not community property, any recovery on the community property basis shall be limited to the net amount after giving effect to the resulting tax due from his wife and barred from assessment against her by the statute of limitations.

XVI.

That if plaintiff's complaint is sustained in full he will be entitled to a refund of $7,326.45 income tax for the year 1935 and there would be a deficiency income tax of $3,948.68 for 1935 due from Esther Jeanne Johnson, his former wife, making a net re-

fund of income tax for 1935 of $3,377.77 due plaintiff, plus $450.38 interest to June 11, 1938, the date of payment thereof, or a total of $3,828.15. Plaintiff would be entitled to interest at 6% on said $3,828.15 from June 11, 1938, as provided by law. [5]

XVII.

Said Commissioner in determining the net income of Johnson & Johnston, a partnership, erroneously disallowed deductions claimed by said partnership as follows:

Club dues and expenses of Philip D. Johnston at Bel Air Country Club		$ 587.21
Club dues and expenses of Todd W. Johnson at Los Angeles Country Club	419.42	
at Stock Exchange Club	13.91	433.33
Total Club dues and expenses disallowed		$1,020.54

That said plaintiff had a 75% interest in the net earnings of said partnership and by disallowing said club dues and expenses said Commissioner erroneously increased the net income of plaintiff by 75% thereof, or $775.40. Said club dues and expenses were expended in entertaining clients and prospective clients, and for no other purpose and were a proper deduction for income tax purposes.

XVIII.

Prior to January 1, 1935, said Philip D. Johnston and plaintiff had agreed that said partnership

should pay said club dues and expenses out of the income of the partnership before computing the net income thereof to be distributed in the proportion of 75% to plaintiff and 25% to said Philip D. Johnston. In view of this oral modification of the partnership agreement the net income of plaintiff should only be increased by the amount of the club dues and expenses paid by the partnership for him or $433.33 even if said club dues and expenses are determined by this court not to be proper deductions for income tax purposes.

XIX.

Said claim for refund is the only claim for refund filed by plaintiff in the premises and has not been sold, assigned, or otherwise transferred or disposed of to any other person, and is the property of the plaintiff at the present time.

XX.

The defendant erroneously and illegally collected from the plaintiff and is illegally withholding from plaintiff, and is indebted to the plaintiff in the [6] sum of $3,828.15, together with interest thereon from June 11, 1938, as provided by law, representing amounts illegally exacted from plaintiff as Federal Income Tax for the year 1935, and interest thereon to June 11, 1938. Although often demanded by plaintiff, defendant has not, nor has anyone for it, repaid or refunded said sum or any part thereof to plaintiff, or to anyone else for plaintiff's use, benefit or account.

FOR ANOTHER FURTHER AND SECOND CAUSE OF ACTION

I.

Plaintiff realleges and here incorporates in this his second cause of action Paragraphs I to XX, inclusive, of his First Cause of Action, and such reference makes the same a part of this cause of action the same as if specifically set forth herein.

II.

During said negotiations leading up to said property settlement agreement set forth in Paragraph XII plaintiff offered to transfer to said Esther Jeanne Johnson one-half of all community property then owned and in addition to pay her one-half of his collection from fees received for legal services as an attorney up until the date a final degree of divorce was entered, all of which constituted her vested one-half interest in the community estate. Esther Jeanne Johnson rejected this offer stating that she desired to receive specific properties, free and clear of debt, and a definite amount of cash rather than to have a one-half interest in all the community property, including one-half of an indefinite amount of cash from fees as collected by plaintiff.

III.

As a result of said negotiations said property settlement agreement was entered into. Pursuant to said property settlement agreement and in complete performance by plaintiff of its terms he transferred

to Esther Jeanne Johnson property of a value at least $26,010.42 in excess of the value of her one-half interest in the community property existing on March 4, 1935, other than fees earned by plaintiff. [7]

IV.

Under said property settlement agreement plaintiff purchased from Esther Jeanne Johnson her one-half interest in the fees earned by plaintiff individually and as a partner in the partnership of Johnson & Johnston, by transferring to her property and cash worth at least $26,010.42 more than the value of her one-half of the community property other than such fees.

V.

Plaintiff was entitled to recover said $26,010.42 out of the one-half community share of Esther Jeanne Johnson in said fees which were earned but not collected, before he received any income from the collection thereof.

Wherefore, plaintiff prays judgment against the defendant in the amount of $3,828.15 together with interest thereon from June 11, 1938, as provided by law, and for plaintiff's costs of suit, and for such other and further relief as the Court may deem meet and proper in the premises.

PHILIP D. JOHNSTON
OTIS T. GRAHAM, Jr.
Attorneys for Plaintiff [8]

(Duly Verified) [9]

EXHIBIT "A"

PROPERTY SETTLEMENT AGREEMENT

This agreement, made and entered into this 4th day of March, 1935, by and between Esther Jeanne Johnson, also known as E. Jeanne Johnson, Party of the First Part, and Todd W. Johnson, Party of the Second Part, each of said parties being residents of the City of Los Angeles, County of Los Angeles, State of California;

Witnesseth:

That, whereas, the parties to this agreement are husband and wife, and owners of certain real and personal property accumulated during their married life, the title to some of which property is held in joint tenancy and the title to some of which property is held in the name of Party of the Second Part; and there being certain debts owing by the said parties, including income tax on the income of the parties for the calendar year 1934 and 1935; and

Whereas, the Party of the First Part is about to institute an action for divorce against the Party of the Second Part, and it is the mutual desire of the parties hereto that their respective property interests be by this instrument determined and fixed forever;

Now, therefore, it is agreed:

1. That the Party of the First Part shall have as her sole and separate property that certain real property, the title to which stands in the name of

"Todd W. Johnson and E. Jeanne Johnson, husband and wife, as joint tenants", together with the buildings thereon, which property is known as 868 Birchwood Drive, Los Angeles, California, and which is more particularly described as: [10]

> Lot 43, Tract 8422, as per Maps recorded in Book 117, Pages 72 and 73 of Maps, in the office of the County Recorder of said County.

2. That the said Party of the First Part shall have as her sole and separate property that certain real property, the title to which stands in the name of "Todd W. Johnson and E. Jeanne Johnson, husband and wife, as joint tenants", together with the buildings thereon, which property is known as 9224 to 9240 West Pico, Los Angeles, California, and which is more particularly described as:

> Lots 8, 9, and 10, Tract 7580, as per Map recorded in Book 89, Pages 13 and 14 of Maps in the office of the County Recorder of said County.

3. That Party of the First Part shall have as her sole and separate property all of the furniture, furnishings, fixtures, and equipment contained in the large house located at said 868 Birchwood Drive, Los Angeles, California.

4. That Party of the First Part shall have as her sole and separate property that certain Packard Coupe Automobile, registered in the name of the Party of the Second Part.

5. That Party of the First Part shall have as

her sole and separate property all of her jewelry and personal effects.

6. That the Party of the Second Part shall pay to the Party of the First Part for her support and maintenance the sum of Five Hundred ($500.00) Dollars a month for a period of twelve (12) months, commencing as of March 1, 1935; said amount to be payable at the rate of Two Hundred Fifty ($250.00) Dollars on the first and fifteenth of each month until the total sum of Six Thousand ($6,000.00) Dollars is paid.

7. That Party of the Second Part, in consideration of making the monthly payments to Party of the First Part, shall receive all of the rents payable or accrued for a period of twelve (12) months, commencing as of March 1, 1935, upon the [11] property known as Lots 8, 9, and 10, Tract 7580. Party of the Second Part agrees to pay, prior to delinquency, all taxes and lighting assessments levied against said real property known as Lots 8, 9, and 10, Tract No. 7580, for and during the fiscal year from July 1, 1935 to and including June 30, 1936; and during the twelve months period, commencing as of March 1, 1935, Party of the Second Part agrees to keep the building and improvements on said real property fully insured in the name of the Party of the First Part at his own cost and expense; agrees to pay the cost of the maintenance and upkeep of said real property; and agrees not to do, or cause or permit to be done, or create, cause to be created, or permit to exist any act, thing, or condition with respect to

said real property which might be prejudicial to the rights and interests of Party of the First Part.

8. That Party of the Second Part shall have as his sole and separate property the real estate hereinafter described, the title to which real estate is held in the manner listed below the description of each property:

(a) That portion of Lots 21 and 22 of Tract No. 6073 as recorded in Book 63, page 13 of Maps, records of Los Angeles County, bounded and described as follows, to-wit:

Beginning at the Southwest corner of Lot 19 of the above mentioned Tract No. 6073; thence N. 84° 30′ 30″ E. 40 ft.; thence S. 21° 50′ 12″ E. 290.25 ft.; thence S. 79° 04′ 15″ E. 102.58 ft.; thence S. 32° 08′ 16″ W. 743.77 ft. to a point in the center line of Benedict Canyon Road as shown on the aforesaid map of Tract No. 6073, said point being also the beginning of a curve concave to the Southwest and having a radius of 280 ft., a radial line from said curve at said point of beginning bears S. 40° 19′ 40″ W. thence northwesterly along said curve thru an angle of 19° 08′ 05″ and an arc of 93.51 ft. to end of said curve; thence N. 21° 11′ 35″ E. 20 ft. to the most westerly corner of the above mentioned lot 22; thence N. 21° 43′ 30″ E. 653.75 ft.; thence N. 5° 13′ 25″ W. 242.34 ft. to the point of beginning of this description, containing an area of 3 acres more or less, excepting therefrom that portion of easement granted

to the City of Los Angeles by deed recorded in Book 2110 page 391 Official Records of Los Angeles County; also [12] excepting therefrom any and all portions of Benedict Canyon Road included within the above description; also excepting therefrom an easement for right of ingress and egress 22 ft. wide lying 11 ft. on either side of the following described center line, beginning at a point N. 84° 30′ 30″ E. 20 ft. from the aforesaid southwest corner of Lot 19; thence S. 5° 29′ 30″ E. 33 ft.; thence S. 28° E. 168 ft.; thence S. 2° 30′ W. 210 ft.; thence S. 56° E. 30 ft.; thence N. 64° E. 80 ft. more or less, excepting therefrom any portion of last described easement lying in the aforesaid easement as recorded in Book 2110, Page 391, Official Records.

Title to the next above described property is held in the name of "Todd W. Johnson". This is a vacant parcel of land which was received as a fee from the Ince Corporation.

(b) Lot 49, Tract 8025, as per Map recorded in Book 100, Pages 3 and 4 of Maps, records of Los Angeles County, State of California.

Title to the next above described property is held in the names of "Todd W. Johnson and Esther Jeanne Johnson, husband and wife, as joint tenants". This property is a vacant lot located in the County near the town of Pico, California.

(c) Lots 142, 161, 162, 163, 164, and 165

of Tract 5070, in the City of and County of Los Angeles, State of California, as per Map recorded in Book 57, Pages 53 and 54 of Maps in the office of the County Recorder of said County.

Title to the next above described property is held in the names of "Todd W. Johnson and E. Jeanne Johnson, his wife, as joint tenants". This property is known as 1101-1119 South La Brea, Los Angeles, California.

9. That Party of the Second Part shall have as his sole and separate property the following personal property, the title to which stands in his name:

300 shares of Citizens National Trust & Savings Bank stock;

200 shares of Dunhill International stock;

His interest in the partnership of Johnson & Johnston, attorneys-at-law;

All bank accounts standing in his name;

The Auburn Sedan Automobile;

Any fees outstanding for services performed by Party of the Second Part; and

Any other real or personal property standing in the name of either the Party of the First Part or Party of the Second Part, or in the name of both of them as joint tenants and not specifically mentioned herein as being the sole and separate property of Esther Jeanne Johnson. [13]

10. The parties hereto further agree that they

will execute quitclaim deeds of their record interests in the real estate hereinabove mentioned to confirm the record title to this agreement; and further agree that they will execute any necessary conveyances or releases of the personal property mentioned above to insure each of the parties hereto having a clear title to their personal property in accordance with this agreement. It is further agreed that this agreement may be construed as a quitclaim deed, passing title from the one party hereto to the other of the various and respective interests by this agreement agreed to be passed, and that it may be construed as a Bill of Sale, passing title from the one party hereto to the other of the various and respective interests in the personal property agreed to be passed; but, nevertheless, each of the parties hereto agrees to execute upon demand any other or further document that might be deemed necessary or convenient in order to fully and faithfully effectuate the objectives and purposes hereof.

11. Party of the Second Part further agrees to assume and pay the income tax due from both parties for the calendar years 1934 and 1935, any other debts contracted by Party of the Second Part, and any debts contracted by either or both of the parties while they were living together.

12. Party of the Second Part agrees to pay to Party of the First Part, or for her benefit, $750.00 for attorneys' fees, together with court costs incurred, or to be incurred, in connection with this agreement and in connection with any divorce action

that party of the First Part might institute against Party of the Second Part.

13. It is further agreed that this agreement shall be in lieu of all other compensation or claims of any kind in favor of either party against the other; and that henceforth neither [14] party will be responsible for the debts or obligations of the other, except as above provided.

14. It is agreed that this agreement may be incorporated in any decree that might be rendered in any divorce action between the parties hereto; and the parties hereto hereby expressly consent to any court order conforming herewith.

15. It is expressly understood and agreed that this agreement supersedes any previous agreement, oral or in writing, between the parties hereto with respects to their respective property rights; and any such previous agreements are hereby expressly abrogated, annulled, and pronounced to be of no further force or effect.

In witness whereof, we have hereunto set our hands and seals the day and year first above mentioned.

ESTHER JEANNE JOHNSON
Party of the First Part

TODD W. JOHNSON
Party of the Second Part [15]

State of California
County of Los Angeles—ss.

On this 4th day of March, 1935, before me, the undersigned, a Notary Public in and for said County and State, personally appeared Esther Jeanne Johnson, also known as E. Jeanne Johnson, known to me to be the person whose name is subscribed to the within instrument, and acknowledged to me that she executed the same.

In witness whereof, I have hereunto set my hand and affixed my official seal the day and year in this certificate first above written.

MARY K. SUTER
Notary Public in and for said
State and County.

My Commission Expires July 17, 1935

State of California
County of Los Angeles—ss.

On this 4th day of March, 1935, before me, the undersigned, a Notary Public in and for said County and State, personally appeared Todd W. Johnson, known to me to be the person whose name is subscribed to the within instrument, and acknowledged to me that he executed the same.

In witness whereof, I have hereunto set my hand and affixed my official seal the day and year in this certificate first above written.

MARY K. SUTER
Notary Public in and for said
State and County.

My Commission Expires July 17, 1935. [16]

EXHIBIT "B"

CLAIM

To be filed with the Collector where assessment was made or tax paid.

Form 843 Treasury Department Internal Revenue Service Revised June 1930

Collector's Stamp (date received)

The Collector will indicate in the block below the kind of claim filed, and fill in the certificate on the reverse side.

[ ] Refund of tax illegally collected.

[ ] Refund of Amount Paid for stamps unused, or used in error or excess.

[ ] Abatement of tax assessed (not applicable to estate or income taxes).

State of California
County of Los Angeles—ss.

[Type or Print]

Name of taxpayer or purchaser of stamps—Todd W. Johnson

Business address—433 South Spring Street, Los Angeles, California

Residence—1280 Benedict Canyon Drive, Los Angeles, California

The deponent, being duly sworn according to law, deposes and says that this statement is made on behalf of the taxpayer named, and that the facts given below are true and complete:

1. District in which return (if any) was filed—Sixth California

Exhibit "B" (Continued)

2. Period (if for income tax, make separate form for each taxable year) from—January 1, 1935, to December 31, 1935

3. Character of assessment or tax—Income Tax

4. Amount of assessment, $10,940.84; dates of payment $7,821.89 paid and credited 6/11/38; $3118.95 paid as follows: $779.74 on 2/6/36; $779.74 on 6/4/36; $779.74 on 9/14/36; and $779.73 on 12/10/36.

5. Date stamps were purchased from the Government—

6. Amount to be refunded—$7,148.11

7. Amount to be abated (not applicable to income or estate taxes) $—

8. The time within which this claim may be legally filed expires, under Section— of the Revenue Act of 19—, on June 11, 1940.

The deponent verily believes that this claim should be allowed for the following reasons:

See attached rider which is made a part hereof by reference.

(Attach letter-size sheets if space is not sufficient)

Sworn to and subscribed before me this — day of — 193 (signature of officer administering oath)

(Title)

Signed.....

(See instructions on reverse side) [17]

Exhibit "B" (Continued)

CERTIFICATE

I certify that an examination of the records of this office shows the following facts as to the assessment and payment of the tax:

Claim No.....

Character of assessment and period covered, List, Year, Month, Account No. or Page, Line, Amount assessed $..... Total $.....

Paid, Abated, or Credited, Date, Amount $..... Total, $..... Claim No.....

I certify that the records of this office show the following facts as to the purchase of stamps:

To Whom Sold or Issued, Kind, Number, Denomination, Date of sale or issue, Amount $.....

If special tax stamp, state: Serial number, Period commencing—

Collector of Internal Revenue (District)

Committee on claims

Amount claimed $.....

Amount allowed $.....

Amount rejected $.....

Claim examined by— Claim approved by— Chief of Division.

Instructions

1. The claim must be set forth in detail and under oath each ground upon which it is made, and facts sufficient to appraise the Commissioner of the exact basis thereof.

Exhibit "B" (Continued)

2. The claim should be sworn to by the taxpayer, if possible. Whenever it is necessary to have the claim executed by an attorney or agent, on behalf of the taxpayer, an authenticated copy of the document specifically authorizing such agent or attorney to sign the claim on behalf of the taxpayer shall accompany the claim. The oath will be administered without charge by any collector, deputy collector, or internal revenue agent.

3. If a return is filed by an individual and a refund claim is thereafter filed by a legal representative of the deceased, certified copies of the letters testamentary, letters of administration, or other similar evidence must be annexed to the claim, to show the authority of the executor, administrator, or other fiduciary by whom the claim is filed. If an executor, administrator, guardian, trustee, receiver, or other fiduciary files a return and thereafter refund claim is filed by the same fiduciary, documentary evidence to establish the legal authority of the fiduciary need not accompany the claim, provided a statement is made on the claim showing that the return was filed by the fiduciary and that the latter is still acting.

4. Where the taxpayer is a corporation, the claim shall be signed with the corporate name, followed by the signature and title of the officer having authority to sign for the corporation.

Exhibit "B" (Continued)

The Commissioner of Internal Revenue erroneously determined that taxpayer had the following net income for the calendar year 1935:			$54,860.13
1. The Commissioner of Internal Revenue erroneously determined that taxpayer was taxable on all of the following fees whereas he was only taxable on one-half thereof:			
Viber Company legal work	$ 112.00		
Ray Tracy Income tax work	55.00		
Wm. G. Kerckhoff Estate Tax case	31,791.67		
Total Fees	31,958.57		
One-half		$15,979.28	
2. The Commissioner erroneously determined that taxpayer's taxable distributable share of the earnings of Johnson & Johnston, a partnership, was $23,912.41 whereas his correct taxable share was $13,881.27, a difference of		10,031.14	
Total excess income as determined by the Commissioner			26,010.42
Correct Net Income			$28,849.71
Tax liability as determined by Commissioner		10,940.84	
Correct tax liability		3,792.73	
Overassessment		$ 7,148.11	

In the agreement signed by taxpayer on April 20, 1938, waiving the restrictions on assessing the tax determined by Commissioner the taxpayer agreed as follows:

Exhibit "B" (Continued)

"2. The taxpayer has not agreed not to file a claim for refund, but should he file a claim for refund or court action for recovery of tax paid by him for the year 1935 on income held to be his separate property and not community property, that any recovery on the community property basis shall be limited to the net amount after giving effect to the resulting tax due from his wife and barred from assessment by the statute of limitations."

Accordingly, the taxpayer is entitled to a refund of $7,148.11, plus interest as allowed by law on his payments of tax and interest, less the [18] amount of tax which should have been paid by taxpayer's ex-wife, Esther Jeanne Johnson (now Haskell).

DISCUSSION OF FACTS AND LAW INVOLVED

1. The Viber Company and Tracy fees were for work completed long prior to January 1, 1935, but they were unable to pay the fees in full and paid in installments.

The Wm. G. Kerckhoff Estate tax fee was for a case completed prior to March 4, 1935, the date taxpayer entered into a property settlement with his then wife, Esther Jeanne Johnson. A total fee of $42,398.93 had been fixed and agreed to on this case prior to March 4, 1935. However, payment was not demanded nor received until after March 4, 1935.

Exhibit "B" (Continued)

Todd W. Johnson, the taxpayer, and Phillip D. Johnston, on May 26, 1933, entered into a partnership agreement. At that time the two partners surveyed the work done and to be done on this case and agreed that the case was 75% completed and accordingly it was agreed that 75% of the ultimate fee would be paid to Todd W. Johnson and 25% of the fee would be paid to Johnson and Johnston. When the fee was collected 75% or $31,791.67 was received by Todd W. Johnson and 25% or $10,597.26 was received by the partnership of Johnson and Johnston.

On March 4, 1935, the sum of $31,791.67 represented an account receivable due Todd W. Johnson and the sum of $10,597.26 represented an account receivable due Johnson & Johnston. Inasmuch as these accounts receivable were for services performed between 1929 and March 4, 1935, while taxpayer was married to Esther Jeanne Johnson, they were property and the community property of taxpayer and said Esther Jeanne Johnson.

Any fees earned by Todd W. Johnson prior to the property settlement agreement of March 4, 1935 were clearly the community property of Todd W. Johnson and Esther Jeanne Johnson. If no property settlement had been agreed to and the parties were finally divorced, the said Esther Jeanne Johnson would have been entitled to receive her one-half community interest in all fees earned prior to the final divorce.

Exhibit "B" (Continued)

To illustrate this point reference is made to the case of King v. Commissioner, 26 B.T.A. 1158, 13 A.F.T.R. 747. In this case the lawyer entered into a contingent fee contract with a client and thereafter the wife died. At her death a favorable judgment in the lower court had been obtained by such lawyer, but the case had been appealed. After her death a settlement was made whereby the lawyer's client was paid a sum somewhat less than the judgment which had been obtained in the lower court. His contingent fee was of course also collected after the death of his wife. In filing his income tax return, the lawyer included only one-half of this contingent fee and claimed that his wife's [19] estate was taxable on the other one-half. The Commissioner held that the lawyer was taxable on all of this contingent fee, and that the wife's estate was taxable on none of it.

The Court in a well reasoned opinion held that the husband was taxable only on one-half of this fee and used the following language:

> "The fact that the marital relationship was dissolved by death before the condition was fully performed does not affect the property interest in the fee when it was received because * * * it is the time of the inception of the initial right which determined the status of the property * * *"

Manifestly, the dissolution of the marital relationship either by divorce, or death, could not

Exhibit "B" (Continued)

change the status or property interest in fees already earned when such relationship was dissolved. Therefore it is quite clear that in the absence of any specific agreement a divorced wife would retain her one-half community interest in fees earned prior to a divorce.

From the above it is quite clear that, despite the divorce, had there been no community property settlement one-half of all fees earned prior to March 4, 1935 would have been the community property of Todd W. Johnson and Esther Jeanne Johnson, and said Todd W. Johnson would have been taxable only on one-half thereof, because said Esther Jeanne Johnson would have received one-half thereof as her part of the community property. It is also clear that a husband and wife may agree between themselves that all present or future earnings of either spouse shall be the separate property of the particular spouse earning the same. If the particular spouse giving up his or her one-half community share of such earnings does so without consideration the lower court and Board decisions seem to erroneously hold that such earnings become the separate property of the particular spouse earning the same and he or she is taxable on 100% thereof. H. G. Ferguson v. Commissioner, 34 B.T.A. 522. The claim is made herein that until a final divorce decree is entered, said income is taxable one-half to the husband and one-half to the wife.

Exhibit "B" (Continued)

Furthermore, under the laws of California a husband and wife may enter into any valid contract with each other including a purchase or sale contract. California Civil Code, Section 158; Ran v. Ran, 100 Cal. 276, 34 Pac. 775; Smith v. Smith, 47 Cal. App. 650, 191 Pac. 60; Gray v. Perlis, 76 Cal. App. 511, 245 Pac. 212; Rayburn v. Rayburn, 54 Cal. App. 69, 200 Pac. 1064; Grant v. Commissioner, 29 B.T.A. 760.

Inasmuch as a husband can enter into any valid contract with his wife, Todd W. Johnson could and did agree to purchase from Esther Jeanne Johnson all of her community one-half interest in the fees earned prior to March 4, 1935. Had he paid her a specific sum in cash for her community one-half interest in such fees the matter would appear quite [20] simple. In the case of Helvering v. Smith, 90 Fed. (2d) 590, 199 A.F.T.R. 889, the retiring partner in a law partnership was paid by the remaining partners a lump sum of $125,000.00 for his interest in the legal fees earned prior to his retirement. The court rejected the theory that the transaction was strictly a sale of partnership interest, but held that it was a present payment for "income already earned but not reported by a cash receipts taxpayer until collected from the firm's clients. As all such collections would be taxable as ordinary income the replacement of such future income with the cash payment was held to result in present taxation in the same manner."

Exhibit "B" (Continued)

As stated in Helvering v. Smith, Supra, except for this purchase and release, Todd W. Johnson would have "turned over to" her, her "existing interest in earnings already made." "The commuted payment merely replaced the future income with cash."

On the facts in the Smith case it is believed that anyone would concede that the remaining partners were entitled to recover the $125,000.00 paid to Smith, out of his former percentage of the fees, before the remaining partners would receive any income from the collection of his former share of the fees. See Hallowell, et al., v. Commissioner, decided January 5, 1939, 39 B.T.A. 7, Para. 6.103, Prentice Hall B.T.A. decisions for 1939. The principle of this case and the other mentioned above when applied to the present situation would mean that to the extent that Todd W. Johnson paid Esther Jeanne Johnson in cash and property for her one-half community interest in such fees, that he is entitled to recover such cost before he receives any income by reason of the collection of her community one-half share of such fees.

In making such property settlement of March 4, 1935, Todd W. Johnson had a number of discussions with the attorneys for Mrs. Johnson during which the community property then owned and the legal fees earned but not paid were considered at great length. The amount of such fees earned but not collected received careful consideration and es-

Exhibit "B" (Continued)

timates were made by Mr. Johnson and the attorneys as to the probable amount thereof. Mrs. Johnson was entitled to receive an undivided one-half interest in all property owned plus her one-half share in fees earned but not collected. She preferred to receive a lump sum settlement in property and cash so that she and Mr. Johnson would not own interests in the same property. When the settlement was actually agreed to, she received considerably more than one-half of the community real and personal property other than such fees, and also received $6,000.00 in cash. Both Mr. Johnson and the attorneys for Mrs. Johnson considered that the excess property and cash received by her was in lieu of and in payment for her share in such fees earned but not collected.

Todd W. Johnson, the taxpayer, claims that he is not taxable on any part of the $27,333.38 collected by him in the year 1935 which was earned prior to March 4, 1935, but represented the community one-half share of Mrs. Johnson in such fees because of the fact that he paid the [21] full value in property or cash in such property settlement. A case illustrating this point is that of McWilliams, 15 B.T.A. 329, where it was held that where a taxpayer purchased the interest of his partner in the profits earned during the current year, that such profits were not taxable income to the taxpayer as they were acquired in a capital transaction. Also see Bull v. United States, 295 U.S. 247, 55 Sup. Crt. 695, 15 A.F.T.R. 1069.

Exhibit "B" (Continued)

2. The community one-half interest of Mrs. Johnson is the sum of $10,031.14 in the firm of Johnson and Johnston is arrived at as follows:

Bartholomae Oil Corp. fee	$ 2,957.50
John B. Newman Estate fee	1,500.00
John Gilbert fee	1,000.00
Gertrude Titus-Reeves Estate fee	2,700.35
Crosby Productions Inc. fee	300.00
Aztec Brewing Co. fee	1,000.00
Carver Investment Co. fee	340.86
Will E. Keller Estate fee	1,500.00
L. M. McDonald fee	795.15
Kerckhoff Estate Tax fee	8,477.81
Kerckhoff County Tax case fee	6,188.04
Total	$26,759.71
75% of Todd W. Johnson and Esther Jeanne Johnson	$20,062.28

The Bartholomae Oil Company fee was in connection with transferee income taxes completed July 13, 1933. The corporation was not in a financial position to pay the total fee when the work was finished and a balance of $2,957.50 was collected during the year 1935.

The John B. Newman Estate fee involved an estate tax case completed October 14, 1932. This estate was financially unable to pay the total fee when the work was completed and $1,500.00 was received on this fee in the year 1935.

The John Gilbert fee represented income tax work completed in March, 1934. We neglected to send out a bill for this fee of $1,000.00 until 1935, at which time it was paid.

Exhibit "B" (Continued)

The Gertrude Titus-Reeves estate fee of $2,700.35 involved an estate tax net which was completed during November of 1934. The fee was billed on January 7, 1935 and paid on January 11, 1935.

The Crosby Productions Inc. fee of $300.00 represents a bookkeeping charge for this corporation for October, November, and December, [22] 1934. These books were kept by an accountant in our office and bills were always sent in the month following the completion of a full quarter's work.

The Aztec Brewing Company fee of $1,000.00 was for income tax work during the year 1933, to October 31, 1934.

The Carver Investment Company fee of $384.86 involved a tax case which was completed November 5, 1934.

The Will E. Keller Estate fee of $1,500.00 represented a payment on account of work done prior to March 4, 1935. The total amount due for work done prior to March 4, 1935, was in excess of $1,500.00 but this payment was received on account during the year.

The L. M. McDonald fee involved income tax work completed in 1935. Our record shows that 35½ hours' work was done prior to March 4, 1935, and eight hours' work was done after that time. The work was more than 80% complete as of March 4, 1935, and the total fee received was $981.44. I have treated 80% of the fee, $785.15, as having been earned prior to March 4, 1935.

Exhibit "B" (Continued)

The Kerckhoff estate tax fee of $10,597.26 represents 25% of the total fee heretofore mentioned, the said 75% having been paid to Todd W. Johnson for work done prior to May 26, 1933. More than 80% of the remaining work to be done on this case was completed prior to March 4, 1935. However, I have treated only 80%, or $8,477.81, of the fee as having been earned prior to that time.

The Kerckhoff county tax case involved a total fee of $9,576.51 of which the amount of $6,188.04 was collected in 1935, and $3,488.47 in February of 1936. The total time spent on this case was 400½ hours, of which 305½ hours had been spent prior to March 4, 1935. Inasmuch as more than $6,188.04 had been earned prior to March 4, 1935, I have treated the entire amount collected as having been earned prior to that time.

The reasons why the community one-half interest of Esther Jeanne Johnson in the fees of Johnson and Johnston are not taxable to Todd W. Johnson are the same as mentioned with reference to the individual fees of Todd W. Johnson. Such reasons will not be repeated here but are hereby incorporated by reference. [23]

In addition to the above errors the Commissioner added to the partnership income of Todd W. Johnson $775.40 by disallowing $1,020.54 Club dues paid for the partners. The item is made up as follows:

Club dues and expenses of Philip D. Johnston at Bel Air Country Club	$ 587.21

Exhibit "B" (Continued)

Club dues and expenses of Todd W. Johnson at Los Angeles Country Club	419.42
Club dues and expenses of Todd W. Johnson at Stock Exchange Club	13.91
Total	$ 1,020.54

All of these payments represented ordinary and necessary business expense of the partnership, and the net income of Todd W. Johnson should be reduced by $775.40. Furthermore, should the Commissioner be sustained in disallowing these expenses, the income of Todd W. Johnson should have been increased only by $433.33, the expense paid for him and not by $775.40 which latter figure represents 75% of the expenses paid for both partners. [24]

EXHIBIT "C"

TREASURY DEPARTMENT

Washington

Sept. 21, 1940

Office of
Commissioner of Internal Revenue

Address reply to
Commissioner of Internal Revenue
and refer to
IT:CL:CC: 4-CCP

Mr. Todd W. Johnson,
433 S. Spring Street,
Los Angeles, California.

In re: Claim for refund of $7,148.11.

For the year 1935.

Sir:

Reference is made to the revenue agent's report upon an investigation of your tax liability dated July 9, 1940, a copy of which was forwarded you, wherein you were informed that the claim for refund indicated above will be disallowed.

In accordance with the provisions of existing internal revenue law, notice is hereby given of the disallowance of your claim in full.

Respectfully,
GUY T. HELVERING
Commissioner.

By G. MOONEY
Deputy Commissioner.

[Endorsed]: Filed Oct. 1, 1940. [25]

[Title of District Court and Cause.]

DEFENDANT'S ANSWER

ANSWER TO FIRST CAUSE OF ACTION

Comes now the defendant in above-entitled action and in answer to the first cause of action of plaintiff's complaint herein, admits, denies and alleges:

I.

Admits the allegations contained in Paragraph I thereof.

II.

Admits the allegations contained in Paragraph II thereof.

III.

Admits the allegations contained in Paragraph III thereof.

IV.

Admits the allegations contained in Paragraph IV thereof.

V.

Admits the allegations contained in Paragraph V thereof, except that defendant denies that the Commissioner's determination, referred to in said Paragraph, was erroneous. [26]

VI.

Denies the allegations contained in Paragraph VI thereof, and in that connection alleges that plaintiff had a net taxable income for the year 1935 amounting to $54,860.13.

VII.

Denies the allegations contained in Paragraph VII thereof.

VIII.

States that it is without knowledge or information sufficient to form a belief as to the truth of the allegations contained in Paragraph VIII thereof, but specifically denies that only one-half of said fees and accounts receivable was taxable to plaintiff.

IX.

Denies the allegations contained in Paragraph IX thereof; except that defendant admits that $10,031.14 is one-half of $20,062.28.

X.

Admits the allegations contained in Paragraph X thereof, except that defendant states that it is without information sufficient to form a belief as to the truth of the averment concerning the terms of said partnership agreement, and the averment concerning the identity and amounts of fees that were paid directly to plaintiff.

XI.

Admits the allegations contained in Paragraph XI thereof.

XII.

Admits the allegations contained in Paragraph XII thereof and alleges that said property settlement [27] agreement was dated and executed by the parties on the fourth day of March, 1935.

XIII.

Admits the allegations contained in Paragraph XIII thereof, except that defendant denies that the determinations of the Commissioner in said Paragraph referred to, were erroneous; and denies that plaintiff was taxable only on one-half of said income.

XIV.

Admits the allegations contained in Paragraph XIV thereof.

XV.

Admits the allegations contained in Paragraph XV thereof.

XVI.

States that it is without knowledge or information sufficient to form a belief as to the truth of the allegations contained in Paragraph XVI thereof.

XVII.

Denies the allegations contained in Paragraph XVII thereof, except that defendant states that it is without knowledge or information sufficient to form a belief as to the truth of the averment that plaintiff had a seventy-five per cent interest in the net earnings of said partnership, and the averment that said club dues and said expenses in any amount were spent in entertaining clients and/or prospective clients.

XVIII.

States that it is without knowledge or information sufficient to form a belief as to the truth of the allegations contained in Paragraph XVIII thereof. [28]

XIX.

Admits the allegations contained in Paragraph XIX thereof.

XX.

Denies the allegations contained in Paragraph XX thereof, except that defendant admits that no part of said sum has been repaid or refunded to plaintiff, or to anyone else on his behalf.

ANSWER TO SECOND CAUSE OF ACTION

In answer to the second cause of action of plaintiff's complaint, defendant admits, denies and alleges:

I.

In answer to Paragraph I thereof, defendant by reference incorporates herein its answers to plaintiff's first cause of action and makes said answers a part hereof the same as though expressly set forth herein.

II.

States that it is without knowledge or information sufficient to form a belief as to the truth of the allegations contained in Paragraph II thereof. Defendant, however, denies the materiality and

competency of the allegations contained in said Paragraph and in that connection alleges the fact to be that the terms of said property settlement agreement are certain and unambiguous.

III.

States that it is without knowledge or information sufficient to form a belief as to the truth of the allegations contained in Paragraph III thereof. [29]

IV.

Denies the allegations contained in Paragraph IV thereof.

V.

Denies the allegations contained in Paragraph V thereof.

Wherefore, having fully answered, defendant prays that it be hence dismissed with its costs in this behalf expended.

WM. FLEET PALMER,
United States Attorney.
E. H. MITCHELL,
Asst. U. S. Attorney.
ARMOND MONROE JEWELL,
Asst. U. S. Attorney.
EUGENE HARPOLE,
Special Attorney,
Bureau of Internal Revenue.
By: E. H. MITCHELL,
Attorneys for Defendant.

[Endorsed]: Filed Jan. 4, 1941. [30]

[Title of District Court and Cause.]

OPINION

Todd W. Johnson, Esquire of Los Angeles, California, in propria persona, Plaintiff.

Edward H. Mitchell, Assistant United States Attorney, of Los Angeles, California, for Defendant.

J. F. T. O'Connor, Judge.

This is an action for the recovery of $7,821.89, including interest thereon, which was allegedly illegally assessed against and collected from Todd W. Johnson, the plaintiff, by the United States Department of Internal Revenue, as income tax; and also to allow a certain deduction for business expenses. The controversy is predicated upon the following facts:

During 1921 the plaintiff, Todd W. Johnson, married Esther Jeanne Johnson, and thereafter the plaintiff and his then wife accumulated considerable property, tangible and intangible, in the aggregate amount of $131,839.51. Of this $131,839.51, the sum of $77,220.44 was attributable to the wife's contribution to the community, and $54,619.07 was attributable to the contribution of the plaintiff to the community assets. All of the said property was held either as community property or under joint tenancy.

On January 1, 1935, the plaintiff and his then wife separated and this separation subsequently

resulted in the entry of a final decree of divorce between Todd W. Johnson and Esther Jeanne Johnson on April 2, 1936, the interlocutory decree of divorce having been entered on April 1, 1935. Prior to the divorce, viz. on March 4, 1935, a Property Settlement Agreement had been entered into between the plaintiff and his then wife, Esther Jeanne Johnson, whereby a dissolution of the community character of the property was consummated and the property was divided as is hereinafter indicated: by virtue of the said agreement Esther Jeanne Johnson was allotted miscellaneous properties and cash in the amount of $65,919.75, representing one-half of the entire assets, and Todd W. Johnson was given an equal sum of $65,919.75 as his proportionate share. In the $65,919.75 comprising the plaintiff's one-half interest were included certain accounts receivable amounting to $52,028.45. Said accounts consisted of attorney's fees earned from the plaintiff's practice as an attorney at law, which were collected between March 4, 1935 and December 31, 1935. The income tax on the amounts collected from these accounts receivable is the principal basis of this litigation.

It is the contention of the Government, and conceded by the plaintiff [31] in his closing reply brief, that the transaction between himself and Mrs. Johnson constituted a division or partition of the community and joint tenancy assets, and not a sale or exchange of properties. For this reason the theory of a sale or exchange of properties will not

be further noted. The gift theory advanced by the plaintiff was eliminated from the record by the court at the time of trial.

The plaintiff was a member of the law firm of Johnson and Johnston, wherein Mr. Johnson had a 75% interest, and his partner a 25% interest in the net earnings of the partnership. During the year 1935, $1020.54 was disbursed by the partners, purportedly consisting of necessary club dues and expenses, for the purposes of securing and entertaining prospective clients and otherwise building up the business. By reason thereof the plaintiff claims a deduction of $775.40, which amount represents a 75% interest in the total partnership expenditures for the above club dues and expenses. The Government contends that this deduction should not be allowed because the expenses were not ordinary and necessary and did not directly relate to the partnership business, but were merely for the personal pleasure of the plaintiff.

The two questions involved under the facts are propounded by the plaintiff in his opening brief:

> (1) "What part, if any, of the fees earned by plaintiff as an attorney at law and constituting accounts receivable on March 4, 1935, when a property settlement agreement was executed by plaintiff and his then wife, and which were collected by plaintiff between March 4, 1935, and December 31, 1935, was taxable to plaintiff and what part, if any, was taxable to his then wife?"

(2) "Is plaintiff entitled to deduct as a business expense certain club dues and expenses?"

The solution of the first question requires a determination of the legal effect of the property settlement agreement, and the status of the accounts receivable subsequent to its execution.

Section 158 of the California Civil Code provides in part:

> "Either husband or wife may enter into any engagement or transaction with the other * * * respecting property, which either might if unmarried."

Section 159 also provides that:

> "A husband and wife cannot by contract with each other, alter their legal relations except as to property." [32]

Under these sections the spouses are enabled, by contract, to convert community property into separate property, and vice versa. 12 New Cal. Dig. (McKinney) 485. In consequence of the partition the community assets became the "sole and separate" property of the respective parties by the very terms of the agreement. The legal effect of the transaction was to dissolve the community and joint tenancy character of the property, and transmute the same into separate property. Therefore, the accounts receivable, in the amount of $52,028.45 became the separate property of the plaintiff and were taxable as such when collected, inasmuch as the income tax was levied on a cash basis. The plaintiff strenuously urges that he is taxable, in

any event, for only $17,166.46; this being the difference between $34,861.99 or cost basis to the community placed upon the accounts receivable and the market value of $52,028.45. This contention would be tenable if the subject matter to be taxed were derived from a source which had already been taxed and the property subsequently disposed of at a profit. But here, the accounts receivable were original income and a capital transaction was not involved. The plaintiff is denied recovery.

Answering the plaintiff's second question concerning a deduction of certain club dues as a business expense, the law seems to be well settled. Section 23 of the Internal Revenue Code; 26 U. S. C. A. sec. 23 (a)(1), provides: "All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *," shall be allowed as deductions in computing net income. Among the many cases construing the pertinent provisions of this statute only a few will be cited. In Louis Boehm, 35 B. T. A. 1106, the Board said:

> "It is noted that in cases where expenditures of a social nature have been held to be deductible business expenses, proof was presented to show that such expenditures had a direct relation to the conduct of a business or the business benefits expected * * *" E. E. Dickinson, 8 B. T. A. 722; Wade H. Ellis, 15 B. T. A. 1075; Aff., 50 F. (2d) 343; Blackner v. Commissioner, 70 F. (2d) 255.

Although most of the cases cited in the above quotation denied the requested deduction, yet the principle is the same. Whether or not certain expenditures are deductible as "ordinary and necessary" expense in a particular business, is a question of fact. Willcuts v. Minnesota Tribune Co., 103 F. (2d) 947. [33]

The position of the plaintiff with respect to the necessity of incurring the club dues and expenses in question is disclosed by his uncontradicted testimony. He stated:

> "When I left the Government service in 1929, * * * I had only one piece of business, which was to appraise a large estate for federal estate tax * * * purposes. Along the first part of 1930 I had fairly well finished the appraisement and found myself in the position of having just the one client and no others. I endeavored to contact attorneys and bankers with whom I had casual acquaintances through my work in the Government service, and found that I either couldn't get an appointment with them or if I did get one, they didn't seem to have any particular interest in what I had to talk about, which was my qualifications for assisting them in tax matters. It became apparent to me that I would have to find some means of obtaining their interest by geting better acquainted with them. I found that at least 50% or more of the attorneys and bankers with whom I wished to make contact were

> members of the Los Angeles Country Club. I therefore determined that I would join that club * * * I did this, and from that time until after 1935, I believe that every time I went out to the club I had some particular idea in mind as to whom * * * I would attempt to become friendly with while I was there. I believe I can truthfully say that what success I have had in the legal business has been largely due to my joining the country club."

The plaintiff stated he did not enjoy playing golf; that green fees and food, paid for his prospective clients, were the largest item on his monthly club bill. Plaintiff testified that he did not enjoy golf because he felt he should be working at the office. At the time of the formation of the partnership it was agreed that the club dues and expenses were to be charged as business expenses and were so charged on the books. The facts disclose that the main purpose of the plaintiff in joining the clubs was to obtain business and the plaintiff gave many names of clients secured by his partner and himself in this manner. Large fees were collected from the contacts made at the club. Several clients would not come to his office. The Government demanded and received large income taxes on the fees collected by the plaintiff as a direct result of plaintiff's expenditure in club dues, and the Government cannot refuse to allow plaintiff a deduction as a business expense of the money which produced the business. To rule otherwise would

revive the fable of the goose and the golden eggs.

The evidence also shows that when plaintiff's partner, Mr. Johnston, joined the Bel-Air Country Club for the same purpose, three estates were obtained through his contacts from which fees aggregated in excess of $50,000. The record [34] further indicates that during 1935, due to insufficient help, the plaintiff worked day and night, and frequently on Saturday afternoons and Sundays, and only visited the country club when he felt it absolutely necessary. His membership was "purely from a business standpoint", and was discontinued whenever this method of obtaining business became unprofitable. Without further alluding to the evidence it will suffice to say that the expense incurred by the membership of the plaintiff and his partner in the various clubs, directly contributed to the success of the firm. Under the facts in this particular case, the plaintiff is allowed a deduction as a business expense the amount paid for club dues.

Dated this 29th day of November, 1941.

J. F. T. O'CONNOR,
United States District Judge.

[Endorsed]: Filed Nov. 29, 1941. [35]

[Title of District Court and Cause.]

SPECIAL FINDINGS AND CONCLUSIONS OF LAW PROPOSED AND REQUESTED BY PLAINTIFF

I.

The Court adopts as it Findings of Fact, in part, the facts stipulated at the trial by the parties and introduced as evidence as plaintiff's Exhibit 4, the same as if set forth herein in full.

II.

In the year 1921 the plaintiff married Esther Jeanne Johnson. From 1925 until January 1, 1935, they lived together as husband and wife in the State of California. They separated permanently on the last named date.

III.

Thereafter, and on the 4th day of March, 1935, they executed a written agreement, bearing date the said day, a true copy of which is attached to plaintiff's complaint and there marked Exhibit "A". In and by such agreement the property rights and interests of the parties were finally and forever settled, the obligations of the respective spouses, growing out of their marriage relation, were discharged, and all claims of every kind of each against the other were finally released. [36]

IV.

All of the then existing property, real and personal, referred to in said agreement was acquired

after July 29, 1927, and was traceable and attributable to the toil and talent of plaintiff alone while the spouses resided together in California. Each parcel of real estate described in said agreement as standing in the names of the spouses as "joint tenants," was, on March 4, 1935, the separate property of each to the extent of undivided halves thereof. All of the balance of the real and personal property described in the agreement, including the accounts receivable representing legal fees earned but not collected and the community 75% share of the accounts receivable of the law firm of Johnson & Johnston, was. on March 4, 1935, "community" property of the California type acquired after July 29, 1927.

V.

In entering into said contract of March 4, 1935, each of the spouses, insofar as the property therein described is concerned, intended to and did thereby so dispose of and transform such property that each thereafter would own, as his and her separate property, specific portions thereof in kind as nearly equal in value as possible.

VI.

On March 5, 1935, Esther Jeanne Johnson filed a suit against the plaintiff in the Superior Court of Los Angeles County, California, praying for a divorce on the grounds of cruelty. On April 1, 1935, said court entered an interlocutory decree of divorce in said action, and its final decree therein

on the 2nd day of April, 1936, completely and finally dissolving the bonds of matrimony between the spouses. The interlocutory decree approved said agreement and ordered that the defendant, plaintiff herein, pay to the plaintiff, wife, "as alimony for her support and maintenance" the sum of $500 a month for twelve months. The latter provision was incorporated in the final decree by reference. A certified copy of the interlocutory decree was personally served upon the defendant, plaintiff in this action, on the 3rd day of April, 1935.

VII.

The agreement by plaintiff to pay and his payment of $500 per month [37] for a period of one year, or a total of $6,000, to his wife, reduced by his collection of rent from the Pico Street property during the same period, was in full satisfaction of and constituted a complete discharge of the rights, if any, which his wife had to receive support, maintenance or alimony from plaintiff. The net rentals from said Pico Street property, collected and received by plaintiff as provided in Article 7 of said property settlement agreement, were $2,179.74. Said net rentals were an offset to and reduction in the amount of alimony which plaintiff agreed to and did pay his said wife as set forth above.

VIII.

The transaction evidenced by said agreement of March 4, 1935, did not constitute reciprocal "sales,"

"exchanges," or "dispositions" of or "dealings in" properties by or between the spouses. It did not constitute reciprocal gifts of property by the spouses, one to the other. Neither party, at the time of the transaction, entertained toward the other a donative intent. The transaction evidenced by said agreement was, insofar as it related to property, in the nature of a division or partition thereof in kind. Insofar as it related to the division in kind of real estate held in joint tenancy, each spouse "conveyed" to the other his or her undivided separate right, title and interest therein, as provided by the agreement, for the purpose of effectuating such division in kind. Insofar as it related to community property, real and personal, each spouse so disposed of or transformed his or her one-half interest in the particular property involved into the separate property of the particular spouse receiving the same.

IX.

The value of the separate and undivided half interest of each spouse in the real estate held by the spouses in joint tenancy was, at the time of the agreement, exactly one-half of the value of the whole property; the value of the undivided one-half interest of each spouse in said community properties, at the time of the agreement, was also exactly one-half of the value of the whole property.

[38]

X.

Following are the market values, as of March 4, 1935, of the joint tenancy and community properties disposed of and transformed by said property settlement into the separate properties of the respective spouses:

Parcels	Values
1. Real estate described in Article 1 of the agreement	$35,000.00
2. Real estate described in Article 2 of the agreement	25,000.00
3. Furniture, etc., described in Article 3 thereof	10,000.00
4. Automobile described in Article 4 thereof	2,000.00
5. Jewelry, etc., described in Article 5 thereof	2,000.00
6. Real estate described in Article 8(a) thereof	1,500.00
7. Real estate described in Article 8(b) thereof	500.00
8. Real estate described in Article 8(c) thereof	$30,000.00
9. 300 shares of Citizens Bank stock (Article 9)	6,000.00
10. 200 shares of Dunhill stock (Article 9)	1,000.00
11. Auburn automobile (Article 9)	1,000.00
12. Cash in bank accounts (Article 9)	6,350.96
13. Accounts receivable owned by the community, representing legal fees earned but not collected	31,958.67
14. Community 75% of accounts receivable of the partnership of Johnson & Johnston	20,069.78
Total market value of joint and community assets	$172,379.41

XI.

The following tabulation sets forth the total original cost of said joint tenancy and community assets set forth in paragraph X above:

Parcels		Cost
1.	Real estate described in Article 1 of the agreement	$39,284.61
2.	Real estate described in Article 2 of the agreement	19,496.50
3.	Furniture, etc., described in Article 3 thereof	15,000.00
4.	Automobile described in Article 4 thereof	2,180.17
5.	Jewelry, etc., described in Article 5 thereof	3,000.00
6.	Real estate described in Article 8(a) thereof	3,000.00
		[39]
7.	Real estate described in Article 8(b) thereof	1,845.28
8.	Real estate described in Article 8(c) thereof	31,355.08
9.	300 shares of Citizens Bank stock (Article 9)	8,095.25
10.	200 shares of Dunhill stock (Article 9)	4,322.50
11.	Auburn automobile (Article 9)	1,500.00
12.	Cash in bank accounts (Article 9)	6,350.96
13.	Accounts receivable owned by the community, representing legal fees earned but not collected	Nil
14.	Community 75% of accounts receivable of the partnership of Johnson & Johnston	Nil
	Total original cost of joint tenancy and community property	$135,430.35

XII.

The total depreciation taken for income tax purposes upon said parcels two and four above, prior to March 4, 1935, amounted to $1,740.84. The total depreciation taken for income tax purposes upon said parcels eight and eleven above before March 4, 1935, amounted to $1,850.00.

XIII.

After its execution and pursuant to the provisions of Article 10 of said agreement, plaintiff made the following expenditures, to-wit:

(1) 1934 tax upon the one-half of the community income of plaintiff	$ 5,082.78
(2) 1934 tax upon the one-half of the community income of plaintiff's wife	5,082.78
(3) 1935 income tax returned in the name of plaintiff	3,118.95
(4) 1935 income tax returned in the name of plaintiff's wife	3,118.95

There were no other debts or liabilities due from or owing by the spouses or the community on March 4, 1935.

XIV.

The cost or basis of each spouse of his or her one-half interest in [40] said joint tenancy and community properties was $65,919.75, representing one-half of $135,430.35, total cost of all of said properties, or $67,715.17, less one-half of the total depreciation sustained and allowed of $3,590.84, or $1,795.42. The cost of each spouse of his or her one-half interest on March 4, 1935, in each particular property owned by the community or by the two spouses jointly was exactly one-half of the total cost to the community or to the two spouses of said particular property.

XV.

Plaintiff's wife received properties, under said property settlement which had an original cost to the spouses, less depreciation, of $77,220.84, and which had a market value on March 4, 1935, of $74,000.00. In addition plaintiff assumed and paid her 1934 income tax of $5,082.78 and the 1935 income tax shown on her return in the sum of $3,118.95.

XVI.

Plaintiff received cash and tangible property which had an original cost to the spouses of $54,619.07 and which had a market value on March 4, 1935, of $46,350.96. Plaintiff also received community accounts receivable, representing legal fees earned but not collected, which had no cost but which had a face value and a market value of $31,958.67. Plaintiff also received the community 75% in the accounts receivable of the law firm of Johnson & Johnston, which had no cost but which had a face value and a market value of $20,069.78. Plaintiff received tangible and intangible properties, including said accounts receivable in the total amount of $52,028.45, having a total cost to the spouses of $54,619.07 and having a market value on March 4, 1935, of $98,379.41. Plaintiff also assumed and paid his wife's 1934 income tax of $5,082.78 and the 1935 income tax shown on his wife's return in the sum of $3,118.95.

XVII.

In the property settlement, plaintiff acquired the one-half interest, having a face and market value of $26,014.23 in certain accounts receivable, representing legal fees earned but not collected, and the one-half interest, having a fair market value of $23,175.48, in other joint and community property, [41] which his wife formerly owned. Plaintiff in the property settlement acquired property having a total fair market value of $49,189.71 which formerly belonged to his wife.

XVIII.

In the property settlement, plaintiff transferred or gave up to his wife his one-half interest in certain joint and community property which had a cost to him of $38,610.41. Plaintiff had already paid an income tax on the $38,610.41 used to purchase his half interest in said property. Also plaintiff, in the property settlement assumed and later paid his wife's 1934 income tax of $5,082.78 and the income tax of $3,118.95 shown on her return. Plaintiff, in the property settlement, gave up property which had cost him $38,610.41, on which he had already paid an income tax, and assumed his wife's debts of $8,201.73, or a total of $46,812.14.

XIX.

In the property settlement, plaintiff's wife acquired the one-half interest, having a market value of $37,000.00, which plaintiff formerly owned in certain joint and community property and also her 1934 and 1935 income taxes in the amount of $8,201.73 were assumed and paid by plaintiff, making a total of $45,201.73 acquired by her in the property settlement.

XX.

In the property settlement, plaintiff's wife transferred or gave up to plaintiff her one-half interest in certain accounts receivable, which had cost her nothing, and also her one-half interest in certain other joint and community property which had cost her $27,309.53. She had already paid an in-

come tax on the $27,309.53 which was used to purchase her half interest in said properties.

XXI.

In the year 1935, the law firm of Johnson & Johnston expended the total sum of $1,020.54 in payment of club dues and club expenses contracted in said year by the two members of the firm for the purpose of securing and entertaining prospective clients and otherwise building up the firm business. [42]

The only purpose of using the club facilities in the taxable year was to obtain legal business; and large legal fees were received by the firm from contacts made in the year 1935 at these clubs. The clubs were used by the partners in the taxable year solely for business reasons and not for social purposes. The cost of said 1935 club activities of the members was both ordinary and necessary to the operation in 1935 of the firm business.

CONCLUSIONS OF LAW PROPOSED BY PLAINTIFF

From the foregoing facts the Court concludes:

I.

Those of the foregoing findings which determine mixed questions of law and fact are adopted as Conclusions of Law the same as though here set forth in full.

II.

The legal effect of the property settlement made between the plaintiff and his wife was to dissolve the community and joint tenancy character of the properties affected thereby, and transmute the specific properties received by each under said settlement into his or her separate property.

III.

The accounts receivable of $31,958.67 owned entirely by the community and the 75% interest of the community in the accounts receivable of Johnson & Johnston, in the sum of $20,069.78, or a total accounts receivable of $52,028.45, representing legal fees earned, but not collected prior to March 4, 1935, received by the plaintiff in said property settlement, became and were his separate property by virtue of the said property settlement agreement.

IV.

The accounts receivable of $52,028.45 were the separate property of plaintiff when collected and his income tax was levied on a cash basis and all of said collections thereof in the sum of $52,028.45 were taxable to plaintiff. [43]

V.

The transfer by plaintiff to his wife of his undivided one-half interest in certain joint and community assets and the transfer by his wife to plaintiff of her undivided one-half interest in the remaining joint and community assets, including

said accounts receivable in the total amount of $52,028.45, which transfers were accomplished by said property settlement, did not constitute reciprocal "sales," "exchanges," "dispositions of," "dealings in" property or any other type of transaction whereby gain or loss was recognized to each or either of the two spouses under the Federal revenue statutes relating to income tax.

VI.

The transformation of said community accounts receivable of $52,028.45 into the separate property of plaintiff was not an assignment without valuable consideration in the nature of a gift to plaintiff from his wife.

VII.

The plaintiff's wife did not, by the transfer of her one-half interest in said accounts receivable in the amount of $52,028.45 to plaintiff and the receipt by her of plaintiff's one-half interest in other property of equal value receive such economic enjoyment therefrom as would make her taxable on one-half of the face and market value of said accounts receivable.

VIII.

Said property settlement was a division or partition of common property on which no gain or loss was recognized to the spouses at the time of said division or partition under the Federal revenue statutes relating to income tax.

IX.

Upon said division or partition of common property, no part of plaintiff's cost of $65,919.75 of his one-half interest, in all of the community and joint properties owned by the two spouses on March 4, 1935, is property allocated to him as the cost or other basis of the one-half [44] interest in said accounts receivable acquired by plaintiff from his wife.

X.

Upon said division or partition no part of his said wife's income tax for 1934 in the sum of $5,082.78 and 1935 in the sum of $3,118.95, assumed and paid by plaintiff in accordance with said agreement, is properly allocated to him as the cost or other basis of the one-half interest in said accounts receivable acquired by plaintiff from his wife.

XI.

Upon said division or partition no part of plaintiff's cost of $38,610.41 of his one-half interest in the specific properties transferred by him to his wife by said property settlement agreement is property allocable to him as the cost or other basis of the one-half interest in said accounts receivable acquired by plaintiff from his wife.

XII.

The collections from the accounts receivable in the total sum of $52,028.45 representing legal fees earned prior to March 4, 1935, and collected by

plaintiff in 1935 after March 4th, were taxable to him alone and were not divisible between him and his wife for Federal income tax purposes. No part thereof was taxable to his wife.

XIII.

The March 4, 1935, disposition, and transformation into plaintiff's separate property, of the community accounts receivable in the amount of $31,958.67 and of the community 75% interest in the accounts receivable of Johnson & Johnston, in the sum of $20,069.78, did not constitute the realization by his wife of income within the purview of the Federal statutes relating to income tax.

XIV.

Such disposition and transformation of such accounts receivable, in the total sum of $52,028.45, when coupled with plaintiff's subsequent collection and receipt thereof, did not constitute the realization by his wife of income within the purview of said statutes. [45]

XV.

The collection by plaintiff of said transformed receivables in the total sum of $52,028.45 constituted the realization of gross income by him to the extent of 100% thereof, without the deduction therefrom of any cost or other basis.

XVI.

Plaintiff is entitled to an additional deduction as a business expense of $775.40 for club dues and club expenses.

XVII.

Plaintiff is entitled to judgment against the defendant for the recovery of $298.21, with interest thereon at the rate of 6% per annum from June 11, 1938, until a date preceding the issuance of a refund check therefor by not more than 30 days; together with his costs herein.

Exceptions allowed plaintiff and defendant.

Dated: June 29, 1942.

J. F. T. O'CONNOR,
United States District Judge.

Approved as to form under rule 8.

WM. FLEET PALMER,
United States Attorney.

E. H. MITCHELL,
Asst. United States Attorney.

By
Attorneys for Defendant.

[Endorsed]: Filed Jun. 29, 1942. [46]

In the District Court of the United States in and for the Southern District of California Central Division.

No. 1195-O'C

TODD W. JOHNSON,

Plaintiff,

vs.

UNITED STATES OF AMERICA,

Defendant.

JUDGMENT

The above entitled cause having been tried before the Court sitting without a jury; plaintiff appearing in propria persona and the defendant appearing by its attorneys William Fleet Palmer, United States Attorney for the Southern District of California, and E. H. Mitchell, Assistant United States Attorney for said district; the cause having been submitted upon the pleadings, the stipulation of facts and oral testimony; the Court having made and caused to be filed herein its written Findings of Fact and Conclusions of Law; and the Court being fully advised in the premises:

It is ordered, adjudged and decreed that the defendant repay and refund to plaintiff as and for Federal income taxes and interest thereon overpaid by plaintiff to defendant for the calendar year 1935 in the amount of Two Hundred Ninety-Eight Dollars and Twenty-one Cents ($298.21), together with interest thereon at the rate of six per cent

(6%) per annum from June 11, 1938, to a date preceding the issuance of the refund check or checks therefor by not more than thirty (30) days, such date to be determined by the Commissioner of Internal Revenue; and that plaintiff have judgment against the [47] defendant for his costs taxed in the sum of

Exceptions allowed both plaintiff and defendant.

Dated this 30 day of June, 1942.

J. F. T. O'CONNOR,
United States District Judge.

Approved as to form as provided by Rule 8:

WILLIAM FLEET PALMER,
United States Attorney.
E. H. MITCHELL,
Assistant United States Attorney.
By E. H. MITCHELL,
Attorneys for Defendant.

[Endorsed]: Filed and Entered Jun. 30, 1942.

[48]

[Title of District Court and Cause.]

NOTICE OF APPEAL

Notice is hereby given that Todd W. Johnson, plaintiff above named, hereby appeals to the United States Circuit Court of Appeals for the Ninth Circuit, from so much of that certain Judgment entered in the above entitled action on June 30, 1942, as holds that because plaintiff on March 4,

1935, in a property settlement with his wife, received certain community accounts receivable of the total face and market value of $52,028.45, representing legal fees earned but not collected, and thereafter during said year collected all of said accounts receivable, said plaintiff realized taxable gross income in 1935 of all or any part of said $52,028.45 thus collected by him.

Dated this 13th day of July, 1942.

TODD W. JOHNSON,
In Propria Persona, Appellant
433 South Spring Street,
Los Angeles, California.

[Endorsed]: Filed & Mld. Copy U. S. Atty. Jul. 13, 1942. [67]

[Title of District Court and Cause.]

STATEMENT OF POINTS ON WHICH APPELLANT INTENDS TO RELY ON APPEAL AND DESIGNATION OF CONTENTS OF RECORD ON APPEAL

To Edmund L. Smith, Clerk of the United States District Court, Southern District of California:

The Appellant intends to rely upon the following points in the above entitled appeal:

I.

That the District Court erred in holding that plaintiff received taxable income of $52,028.45, instead of $26,014.23, when he collected certain ac-

counts receivable representing legal fees earned but not collected, because he owned all instead of one-half interest in said accounts at the time they were collected, notwithstanding the fact that he only owned a community one-half interest therein when said fees were earned and despite the fact that he acquired his wife's community one-half thereof in a property settlement whereby he gave up or conveyed to her his one-half interest in other joint and community property having a cost and value equal to the face and market value of said accounts. [70]

II.

That the District Court erred in holding as a matter of law that the ownership of said accounts at the time they were collected, and not the ownership thereof when they were earned, determined the person or persons who must pay the income tax thereon.

III.

That the District Court erred in failing to hold that the transfer to plaintiff by his wife of her community one-half of said accounts receivable, representing legal fees already earned but not collected, in return for plaintiff's one-half interest in other community and joint property and his payment of her 1934 and 1935 income taxes, was a taxable event or final event of enjoyment whereby she realized income or gain on a cash basis to the full extent of her half interest in said fees.

IV.

That the District Court erred in failing to hold that plaintiff's wife realized gain or loss in the property settlement, computed or based upon the difference between the cost of her one-half interest in certain joint and community property, which she transferred to plaintiff, and the market value of plaintiff's one-half interest in certain other joint and community property which he transferred to her.

V.

That the District Court erred in failing to hold that plaintiff realized gain or loss in the property settlement, computed or based upon the difference between the cost of his one-half interest in certain joint and community property which he transferred to his wife (plus certain of her income taxes assumed and paid by him) and the market value of her one-half interest in said accounts receivable and other joint and community property which she transferred to him.

VI.

That the District Court erred in failing to hold that plaintiff realized no income when he collected the one-half interest in said accounts receivable, representing legal fees earned but not collected, which he acquired from his wife in said property settlement. [71]

VII.

That the District Court erred in failing to hold that said property settlement was a sale, exchange

or disposition of, or dealing in, property whereby gain or loss was realized by each spouse, based upon the difference between his or her cost of the one-half interest conveyed to, and the market value of the one-half interest received from, the other spouse, with proper adjustment for income tax of his wife assumed and paid by plaintiff.

VIII.

That the District Court erred in holding that the property settlement was a transaction whereby no gain or loss was recognized to either spouse.

IX.

In the alternative that, even if the property settlement was a tax free exchange, disposition of or dealing in fractional interests in property, on which no gain or loss was recognized to either spouse, the District Court erred in failing to hold that before plaintiff realized any taxable income when he subsequently disposed of the one-half interest in said fees acquired from his wife by collecting the sum of $26,014.23, he was entitled to recover the sum total of his cost of his one-half interest in certain other joint and community property which he gave up or transferred to her and her 1934 and 1935 income taxes paid by him for her.

X.

The District Court erred in failing to hold that, regardless of whether the property settlement was

a transaction whereby gain or loss was or was not recognized to each or either of the spouses, plaintiff was entitled to recover his cost of his one-half interest in the joint and community property which he transferred to his wife, and the income taxes paid by him for her, before he realized any taxable income from his subsequent disposition by collection of the one-half interest in said accounts acquired from her.

XI.

In the alternative the District Court erred in failing to hold that, if said property settlement was a division or partition of common property on which no gain or loss was recognized to either spouse, plaintiff's cost of $65,919.75 [72] for his half interest in all the joint and community property of the spouses, plus the income taxes of his wife assumed and paid by him in the sum of $8,201.73, should be re-allocated to, and as the cost of, the specific properties received by him, including said accounts receivable, in the proportion which the fair market value of each property received bears to the market value of all the properties received by him.

XII.

In the alternative the District Court erred in failing to hold that, if said property settlement was a division or partition of common property on which no gain or loss is recognized, plaintiff is entitled to recover his allocated cost thereof, com-

puted as set forth in the paragraph next above, before he realized any gain or income from his subsequent disposition of said accounts receivable by collecting them.

You are hereby requested to include in the record on appeal the complete record and all the proceedings and evidence in this action, including specifically the following papers:

1. Complaint.
2. Answer.
3. Stipulation of Facts.
4. Reporter's Transcript of Evidence, including all exhibits of plaintiff and defendant.
5. Opinion.
6. Findings of Fact and Conclusions of Law.
7. Judgment.
8. Notice of Appeal.
9. Clerk's Certificate.
10. This Statement of Points on which Appellant Intends to Rely on Appeal and Designation of Contents of Record on Appeal.

Dated this 13th day of July, 1942.

TODD W. JOHNSON,
In Propria Persona, Plaintiff.

Received copy of the within Statement & Designation this 13th day of July, 1942.

WM. FLEET PALMER,
U. S. Atty.
E. H. MITCHELL,
Asst. U. S. Atty.,
Attorneys for defendant.

[Endorsed]: Filed Jul. 13, 1942. [73]

[Title of District Court and Cause.]

DEFENDANT'S DESIGNATION OF ADDITIONAL CONTENTS OF RECORD ON APPEAL

To Edmund L. Smith, Clerk of the United States District Court, Southern District of California:

In addition to the documents designated by the Plaintiff and Appellant for inclusion in the record on appeal, Defendant-Appellee requests that there be included therein the following, to wit:

(1) Defendant's motion to amend and to make additional findings and conclusions under Rules 52(b) and 59(a)(2), dated and filed herein July 9, 1942, and now noticed for hearing on July 27, 1942.

(2) Any and all orders hereafter made by the Court in response to said motion. [88]

(3) Any and all new and amended findings and/or conclusions hereafter made by the Court of its own motion and/or pursuant to said motion of the Defendant-Appellee.

(4) This designation of additional contents of record on appeal.

(5) The Clerk's certificate in respect thereof.

Attention is called to the fact that the time for the Government to cross-appeal from that portion of the judgment adverse to it will not expire until the 30th day of September, 1942.

In the event of cross-appeal by Defendant, it

requests that there be included in the record on appeal, in order to comply with Rule 75(k) of the Rules of Civil Procedure, the following additional documents, to wit:

(a) Defendant's notice of appeal.

(b) Defendant's statement of points on which it intends to rely on cross-appeal.

(c) This designation and any additional designation of contents of record on cross-appeal hereafter filed by the Defendant.

(d) The Clerk's certificate in respect thereof.

Dated: July 22, 1942.

WM. FLEET PALMER,
United States Attorney.
E. H. MITCHELL,
Assistant United States Attorney.
By E. H. MITCHELL,
Assistant United States Attorney,
Attorneys for Defendant-Appellee.

[Endorsed]: Filed Jul. 22, 1942. [89]

[Title of District Court and Cause.]

CERTIFICATE OF CLERK TO TRANSCRIPT OF RECORD

I, Edmund L. Smith, Clerk of the District Court of the United States for the Southern District of

California, do hereby certify that the foregoing pages numbered from 1 to 90, inclusive, contain full, true and correct copies of Complaint for the Recovery of Federal Income Taxes; Answer; Opinion; Special Findings and Conclusions of Law; Judgment; Plaintiff's Exhibits 1, 2 and 3; Defendant's Exhibits A and B; Notice of Appeal; Bond on Appeal; Statement of Points on which Appellant intends to rely on appeal and designation of Contents of Record on Appeal; Motion to Amend and to Make Additional Findings and Conclusions under Rules 52(b) and 59(a)(2); Minute Order of July 31, 1942; Memorandum; Defendant's Designation of Additional Contents of Record on Appeal and Affidavit of Service, which, together with the Original Reporter's Transcript transmitted herewith constitute the record on appeal to the United States Circuit Court of Appeals for the Ninth Circuit.

I do further certify that the fees of the clerk for comparing, correcting and certifying the foregoing record amount to $17.00 which amount has been paid to me by Appellant.

Witness my hand and the seal of the said District Court this 6th day of August, 1942.

[Seal] EDMUND L. SMITH,
Clerk.
By THEODORE HOCKE,
Deputy.

TESTIMONY

Los Angeles, California
Thursday, September 18, 1941
10:20 O'clock A. M. [2*]

At this time I would like to file a stipulation of facts which have been agreed to by counsel for the parties.

The Court: It will be received.

Mr. Mitchell: Will that be marked as an exhibit or not?

The Court: Yes, I think so.

The Clerk: Plaintiff's Exhibit No. 1.

(The stipulation of facts referred to was received in evidence and marked as "Plaintiff's Exhibit No. 1.")

PLAINTIFF'S EXHIBIT No. 1

[Title of District Court and Cause.]

STIPULATION OF FACTS

It is hereby stipulated and agreed by and between the parties hereto, through their respective attorneys, that the Court may accept the following as part of the facts of this case. Each party hereto expressly reserves the right to offer further evidence not inconsistent with the facts stipulated herein.

I.

That plaintiff, Todd W. Johnson, is now and at all times mentioned herein was a resident of the

*Page numbering appearing at top of page of original Reporter's Transcript.

Plaintiff's Exhibit No. 1 (Continued)

County of Los Angeles, State of California and subject to the jurisdiction of this Court.

II.

Plaintiff is a citizen of the United States of America, has always borne true faith and allegiance thereto, and has never in any way either directly or indirectly aided or abetted anyone in rebellion thereagainst.

III.

The jurisdiction of this Court in the premises is dependent upon a Federal question in that the cause of action arises under the laws of the United States pertaining to the Internal Revenue.

IV.

Plaintiff married Esther Jeanne Johnson in 1921 in the State of Kansas and moved to the State of California in 1925 where they lived together as husband and wife continuously until August 28, 1934, with their residence and domicile in the State of California. Plaintiff entered upon the practice of the law in the City of Los Angeles in June, 1929, at which time plaintiff resigned from the service of the Federal Government, having then no property of any consequence and liabilities in excess of the value of any property then owned by himself and/or his said wife.

V.

On May 26, 1933, plaintiff and Philip D. Johnston, both attorneys at law, formed the partnership of Johnson & Johnston to engage in the practice of

Plaintiff's Exhibit No. 1 (Continued)

the law in the City of Los Angeles, State of California, and plaintiff was a member of said partnership at all times thereafter involved in this action. A true copy of said partnership agreement is attached hereto marked Exhibit 1 and made part hereof by reference.

VI.

The books and records of plaintiff and of plaintiff's law firm of Johnson & Johnston in the year 1935 and prior thereto were kept on the cash receipts and disbursements basis, and all of the income tax returns involved herein, including those of said firm, were made and filed on the cash receipts and disbursements basis.

VII.

On or before March 15, 1936, the plaintiff filed his separate Federal income tax return for the calendar year 1935, reporting therein gross income of $33,610.28 and net taxable income of $26,541.18 and tax payable thereon of $3,118.95 which he paid to defendant during the calendar year 1936. On or before March 15, 1936, said Esther Jeanne Johnson filed her separate Federal income tax return for said calendar year 1935, reporting therein identical amounts of gross and net taxable income and tax payable thereon of $3,118.95 which plaintiff paid for her during the year 1936.

VIII.

Subsequent to March 15, 1936, the Commissioner of Internal Revenue made his audit of plaintiff's

Plaintiff's Exhibit No. 1 (Continued)

said income tax return and determined that plaintiff was liable for a deficiency tax for said year 1935 in the amount of $7,821.89, plus interest of $1,025.84, or a total of $8,847.73.

IX.

In arriving at said alleged deficiency tax of $7,821.89 said Commissioner determined that plaintiff had a taxable net income of $54,860.13.

X.

Said net income figures of $54,860.13 includes the following gross personal fees (as distinguished from partnership fees) received between March 4, 1935, and December 31, 1935, by plaintiff for services performed by him prior to March 4, 1935:

Viber Company fee for legal services	$ 112.00
Roy Tracy fee for legal services	55.00
¾ of Wm. G. Kerckhoff Estate fee for legal services	31,791.67
Total	$31,958.67

The other ¼ of the Wm. G. Kerckhoff Estate fee was the property of said partnership of Johnson & Johnston. All of said amounts totalling $31,958.67 were accounts receivable due to plaintiff personally on March 4, 1935, and were the community property of plaintiff and his then wife, Esther Jeanne Johnson, prior to the separation agreement entered into on March 4, 1935, mentioned hereinafter. Plaintiff included in his 1935 income tax return one-half of said sum of $31,958.67 or the sum of

Plaintiff's Exhibit No. 1 (Continued)

$15,979.39 as his community one-half thereof, and his then wife included the other half thereof in her 1935 return.

XI.

On March 4, 1935, said partnership of Johnson & Johnston had outstanding accounts receivable for legal services rendered by the partners in the total sum of $26,759.71 which were collected between March 4, 1935, and December 31, 1935. Said $26,759.71 consisted of the following partnership accounts receivable for fees earned under contracts entered into by plaintiff individually or by his said law firm on the following dates shown opposite the respective fees:

Name of Client	Amount of Account Receivable	Contract Entered into by Plaintiff	Contract Entered into by Partnership
Bartholomae Oil Corp.	$2,957.50	3/ 1/32	
John B. Newman Estate	1,500.00	9/19/30	
John Gilbert	1,000.00		7/13/33
Gertrude T. Reeves Estate	2,700.35		9/18/33
Crosby Productions Inc.	300.00		7/ 1/33(1)
Aztec Brewing Co.	1,000.00	5/12/33	(2)
Carver Investment Co.	340.86	12/12/32	
Will E. Keller Estate	1,500.00		3/ 4/35(3)
L. M. McDonald	795.15	8/ 2/32	
80% of ¼ of Kerckhoff Estate Tax case	8,477.81	9/26/30	
Kerckhoff Company County Tax case	6,188.04	9/22/31	
Total	$26,759.71		

(1) One-fourth (¼) of annual retainer fee.

(2) One-half (½) of annual retainer fee.

(3) One-half (½) of retainer fee of $3,000.00 contracted for on March 4, 1935.

Plaintiff's Exhibit No. 1 (Continued)

All of the above-listed fee contracts that had been entered into by plaintiff prior to May 26, 1933, were transferred by him on May 26, 1933, to said partnership of Johnson & Johnston and at all times subsequent to said date were the property of said partnership. All of said accounts receivable so collected were included as income in the income tax information return filed by said partnership with said Collector for the calendar year 1935 which showed a gross income of $42,653.82 and a total net income of $32,955.49. The Commissioner determined that said partnership had a net income during 1935 of $33,976.03 which also included said $26,759.71 of accounts receivable as of March 4, 1935. Plaintiff had a seventy-five per cent (75%) interest in said partnership and in said $26,759.71 of accounts receivable, or $20,069.78. The difference of $1,020.54 between the net income returned by the partnership of $32,955.49 and that determined by the Commissioner of $33,976.03, represents the club dues and expenses of the partners as set forth in paragraphs XVII and XVIII of the complaint, which were disallowed by the Commissioner. All of said $26,-759.71 was earned by said partnership between May 26, 1933, and March 4, 1935.

XII.

Of plaintiff's said 75% share of partnership accounts receivable on March 4, 1935, to-wit, $20,-069.78, he reported one-half thereof or $10,034.89

Plaintiff's Exhibit No. 1 (Continued)

and his wife reported the other half in their respective 1935 income tax returns. The Commissioner determined that 100% of said partnership accounts receivable, to-wit, $20,069.78, was taxable solely to plaintiff and none thereof taxable to his wife.

XIII.

After considerable negotiations between the attorneys for Esther Jeanne Johnson and plaintiff a property settlement agreement was entered into on March 4, 1935, between them, a true copy of which is attached to the complaint herein and marked Exhibit "A". Said copy is made a part hereof the same as if set forth herein in full.

XIV.

On March 5, 1935, Esther Jeanne Johnson filed an action in the Superior Court of Los Angeles County, California, against plaintiff praying for a divorce from him on the grounds of cruelty. On April 1, 1935, said court entered an interlocutory decree of divorce, and on April 2, 1936, said court entered a final decree of divorce, completely and finally dissolving and severing the bonds of matrimony between her and plaintiff.

XV.

At the same time that said Commissioner determined that plaintiff owed a deficiency income tax for the calendar year 1935, in the sum of $7,821.89, plus interest of $1,025.84, or a total of $8,847.73, he

Plaintiff's Exhibit No. 1 (Continued)

also determined that said Esther Jeanne Johnson had made an over-payment of her income tax for the calendar year 1935 in the sum of $3,006.80, which she was entitled to have refunded with interest of $328.47, or a total of $3,335.27. This over-payment resulted from the determination by said Commissioner that plaintiff was taxable on all of said individual and partnership income collected between March 4, 1935, and December 31, 1935, instead of only one-half thereof as reported in his return. By agreement between Esther Jeanne Johnson, said Commissioner and plaintiff, said over-payment and interest thereon computed by the Commissioner to have been made by said Esther Jeanne Johnson was credited against said determined deficiency income tax and interest computed by the Commissioner to be due from plaintiff, and on June 11, 1938, plaintiff paid to defendant the difference of $5,512.56.

XVI.

That plaintiff on April 2, 1940, filed his claim for refund with defendant in the sum of $7,148.11. A true copy thereof is attached to the complaint herein, marked Exhibit "B", and is made a part hereof by reference. By letter dated September 21, 1940, addressed to and duly received by plaintiff, said Commissioner rejected plaintiff's said claim for refund in full. A true copy of said letter rejecting said claim for refund is attached to the complaint herein, marked Exhibit "C", and is made a part hereof by reference.

Plaintiff's Exhibit No. 1 (Continued)

XVII.

That as a part of said agreement to credit said overassessment of Esther Jeanne Johnson against said determined deficiency income tax of plaintiff, the said plaintiff agreed with said Commissioner that in the event plaintiff should file a claim for refund or court action for recovery of income tax paid by him for the year 1935 on account of the income so held by the Commissioner to be plaintiff's separate property and not community property, any recovery on the community property basis shall be limited to the net amount after giving effect to the resulting tax due from his wife and barred from assessment against her by the statute of limitations.

XVIII.

Said claim for refund is the only claim for refund filed by plaintiff in the premises and has not been sold, assigned, or otherwise transferred or disposed of to any other person, and is the property of the plaintiff at the present time.

PHILIP D. JOHNSTON
TODD W. JOHNSON
Attorneys for Plaintiff
WM. FLEET PALMER,
United States Attorney
C. H. M.
E. H. MITCHELL,
Asst. United States Attorney
Attorneys for Defendant

Plaintiff's Exhibit No. 1 (Continued)

EXHIBIT 1

ARTICLES OF CO-PARTNERSHIP

Todd W. Johnson and Philip D. Johnston do hereby associate themselves together as co-partners to engage in the practice of law, upon the following terms:

The firm shall be known and do business as Johnson & Johnston;

The firm shall begin business on June 1, 1933, and continue thenceforth, except that either party may terminate it at the end of any calendar year by giving to the other notice at least thirty days before the end of any such year of his desire to terminate the co-partnership.

Todd W. Johnson shall contribute the sum of Three Thousand Dollars ($3,000.00) in cash to the firm's opening bank account at the commencement of business, which sum shall be credited to his personal account and be withdrawable by him wholly or in part when the condition of the said bank account warrants it. Philip D. Johnston shall contribute the sum of One Thousand Dollars ($1,000.00) in cash to the firm's opening bank account at the commencement of business, which shall be credited to his personal account and be withdrawable by him wholly or in part when the condition of said bank account warrants it.

The firm bank account shall be in the joint names of the two partners and be subject to check by either. A set of books shall be kept similar to that

Plaintiff's Exhibit No. 1 (Continued)

heretofore kept by Todd W. Johnson, to be opened June 1, 1933, and to contain all such accounts as may be necessary to properly record the financial affairs of the firm. Said books shall be closed at least as often as December 31st of each calender year so as to show the profits of the business and the condition of the proprietorship accounts.

Todd W. Johnson shall contribute to the business all of his office furniture, fixtures, machinery and books at present employed in his business, at their depreciated value at June 1, 1933, which shall be credited to his capital account. The depreciated value as of said date of his Packard automobile shall also be credited to his capital account. Philip D. Johnston's capital account shall be credited with the value of his Packard automobile on said date at $500.00. Proper asset accounts shall be set up for all said assets so contributed as aforesaid, and depreciation accounts for all depreciated assets.

The profits and losses of the firm's business shall be divided seventy-five per cent (75%) to Todd W. Johnson and twenty-five per cent (25%) to Philip D. Johnston. In computing such profits on losses there shall first be deducted from gross income all salaries of employees of the firm, office rent and other office expenses, the club dues of both partners, depreciation on all depreciable capital assets, and the automobile expenses of both partners on the same basis as such expenses have heretofore been handled on the books of Todd W. Johnson.

The following fees, if, as and when collected

Plaintiff's Exhibit No. 1 (Continued)

shall not be considered partnership fees, but shall be the sole property of Todd W. Johnson: (1) Eli P. Clark 1929 claim for refund; (2) Eli P. Clark Co. 1926 to 1931, inclusive; (3) Del Rey Co. 1930 and 1931; (4) Seventy-five per cent (75%) of the fees hereafter collected from the several cases involving income tax and/or penalties from Canadian corporations or their American Parent corporations; (5) Seventy-five per cent (75%) of the fees hereafter collected from the Wm. G. Kerckhoff Estate Tax cases and State Inheritance Tax cases; (6) The outstanding unpaid balance of the old Cass & Johansing fee; (7) Fees received from the Estate of George F. Getty, deceased and Geo. F. Getty, Inc., on account of services performed prior to June 1, 1933; and (8) all fees received on bills issued prior to June 1, 1933, on cases upon which no more work is to be done. It is assumed for the purpose of these articles that Items (1), (2) and (3) in this paragraph have been closed with the Bureau; if such should not prove to be the case, an adjustment of these fees will hereafter be agreed upon. The fee from the J. B. Newman Estate tax case shall be a partnership fee if and when collected.

Philip D. Johnston shall have as his sole property the first Five Hundred Dollars ($500.00) collected from the Charles Lantz estate under his contract dated March 31, 1933, but thereafter all fees from said case shall be partnership fees.

Todd W. Johnson shall have a drawing account of

Plaintiff's Exhibit No. 1 (Continued)

$1,200.00 per month on account of profits. Philip D. Johnston shall have a drawing account of $400.00 per month on account of profits. At the end of each year each partner shall have the benefit of any undrawn balance of his drawing account, and may withdraw same at his option if the condition of the firm's bank account warrants it, before the distribution of any further profits that may be available for division. The share of each partner in profits not distributed shall be credited to his personal account.

In the event this partnership is terminated by a thirty day notice of either partner as aforesaid, Todd W. Johnson shall be entitled to receive all fees collected on all cases after such termination, except:

1. P. D. Johnston shall be entitled to take with him any case and the fees then due or to become due thereon wherever the client employed him primarily to handle said case in the first instance;

2. If partnership terminates on December 31, 1934, or prior thereto, P. D. Johnston shall be entitled upon said termination to receive Twenty-five (25%) per cent of all fees then actually due whether or not bills therefor have been sent to the particular client, but he shall be entitled to receive no part of the balance due or to become due on any fee when the case is not completed at the date said partnership is terminated.

Plaintiff's Exhibit No. 1 (Continued)

3. Todd W. Johnson shall be entitled to take with him any case and fees then due or to become due thereon wherever the client employed him primarily to handle said case in the first instance.

4. In the event of the death of said Philip D. Johnston at any time there shall be paid to his estate twenty-five per cent (25%) of all fees due whether bills have been sent out or not, and in addition thereto if his death occurs prior to December 31, 1934, there shall be paid to his estate when such fees are collected ten per cent (10%) of all fees on cases in the office on the date of his death but not then completed, except those upon which the fees are specified above as belonging to Todd W. Johnson personally. In the event said death occurs after December 31, 1934, there shall be paid to his estate when such fees are collected fifteen per cent (15%) of all fees collected from all cases then in the office but not completed, except those upon which the fees are specified above as belonging to Todd W. Johnson personally.

5. In the event of the death of said Todd W. Johnson there shall be paid to his estate seventy-five per cent (75%) of all fees then due whether bills have been sent out or not, and in addition thereto there shall be paid to his estate when such fees are collected fifty per cent (50%) of all fees collected on all cases in

Plaintiff's Exhibit No. 1 (Continued)

the office but not completed at the date of his death.

In the event of said termination as aforesaid Todd W. Johnson shall be entitled to the offices, furniture, fixtures, machinery, and books of said partnership, and his automobile and his capital or personal account shall be charged therefor the depreciated cost thereof as of the date of said termination.

Witness our hands and seals this 26th day of May, 1933.

(Signed) TODD W. JOHNSON

(Signed) PHILIP D. JOHNSTON

Subscribed and sworn to before me this 26th day of May, 1933.

[Seal] (Signed) L. C. JOHNSON

Notary Public in and for the County of Los Angeles, State of California.

[Endorsed]: Filed 9-18-41.

Mr. Mitchell: I might make a brief opening statement on behalf of the defendant, if your Honor please. [4]

If the Court should hold that the agreement constituted sales and purchases by the respective parties one from the other, then it will be necessary to determine a very different question, that is, whether either of the parties suffered losses or realized gains from these capital transactions.

It will then be necessary to determine just what the wife gave up, and the value of what she gave up, and determine what the husband gave up, exactly what value that he gave up. It will be necessary to determine the wife's cost basis of what she gave up, as well as the husband's cost basis of what he gave up. [6]

To do that intelligently would require, under the Government's contention, expert testimony because of the peculiar rights of the husband and wife in the co-owned community property.

The Government therefore will object to any testimony as to values, market values, of the property at the time, the cost basis of the property at the time, upon the ground that the transaction was a partition or division and not a capital transaction.

If the Court should hold that they were capital transactions and the agreement constituted sales and purchases between the parties, then the Government feels that it will be necessary to call in experts to testify as to the economic value of the wife's interest, what it cost her, whether there was any cost basis, and so on, and so on. [7]

Mr. Johnson: Mr. Mitchell has stated that he is willing to stipulate that if I were placed on the stand my testimony as to the cost of certain properties to the community and as to the actual market values of those properties on March 4, 1935, would be the same as if I appeared on the stand and testified thereto.

Am I correct in that statement, Mr. Mitchell?

Mr. Mitchell: That is correct, subject to certain objections which I desire to make before the evidence is offered to the Court.

Mr. Johnson: I will ask that this document be marked [8] for identification.

The Clerk: Plaintiff's Exhibit No. 2 for identification.

(The document referred to was marked "Plaintiff's Exhibit No. 2 for identification.")

Mr. Mitchell: Which one is that?

Mr. Johnson: That is the statement entitled "Cost to Community and Market Value of Assets Received by Esther Jeanne Johnson Under Property Settlement Agreement Dated March 4, 1935."

Mr. Johnson: I will now offer as Plaintiff's Exhibit 3, a statement describing several pieces of property and with figures showing the cost therefor to the community, and the market value of each particular parcel of property on March 4, 1935, with the understanding that this statement is to have the same effect as if I had so testified on the stand.

Mr. Mitchell: The defendant will so stipulate subject, however, to certain objections, of course, that such evidence [9] is wholly incompetent, irrelevant, and immaterial, and outside of the issues in this case.

The defendant further objects to such offer for this reason: The offer is made to establish a sale and purchase of accounts receivable by the plaintiff from his wife, or rather her so-called undivided half of those accounts receivable.

That raises the question of whether or not the property settlement agreement constituted sales and purchases. Before the Court can intelligently pass upon the question of whether or not the agreement constituted sales and purchases, I would like to cross examine the plaintiff on that question. [10]

TODD W. JOHNSON

called as a witness by and in behalf of the Government, having been first duly sworn, was examined and testified as follows:

Mr. Mitchell: This witness is called under the rule providing for the calling of adverse witnesses for cross examination. I don't recall the number of the rule, if the Court please.

The Court: I think it is 43, but proceed, Mr. Mitchell.

Direct Examination

By Mr. Mitchell:

Q. You alleged in your complaint, Mr. Johnson, that prior to the execution of the property settlement agreement that you had numerous conferences with Mr. W. I. Gilbert, Mrs. Johnson's counsel, concerning the proposed property settlement agreement? A. I did.

Q. The object of those conferences was to determine the nature and amount and value of the community property for [11] one thing, was it not? That was one of the objects? A. It was.

Q. Mr. Gilbert wanted to know what the com-

(Testimony of Todd W. Johnson.)

munity property consisted of and its approximate value? A. He did.

Q. And another purpose of both parties—withdraw that last.

You had in mind the fact, the understanding, did you not, that Mrs. Johnson was about to sue you for a divorce on the ground of cruelty, or was about to sue you for divorce on some ground?

A. That is correct.

Q. And it was your desire and Mrs. Johnson's desire, acting through her agent, Mr. Gilbert, that the property rights of the parties be settled outside of the divorce action? A. That is correct.

Q. You knew at the time that in the event that the community property questions were submitted to a divorce court that Mrs. Johnson would be entitled to at least one-half in value of the community property, did you not?

A. No, I did not, Mr. Mitchell. I didn't know what the court would hold on that.

I knew that she would have some claim to community property. Just what that would be, I didn't know.

Q. You didn't look at the California statute on that [12] point?

A. Yes, I was familiar with the statute.

Q. At that time?

A. But I also knew that I might file an action against her or a counter-action in case there was any dispute over property.

(Testimony of Todd W. Johnson.)

Q. Now, during these preliminary conferences you revealed to Mr. Gilbert the various pieces of community property and joint tenancy property, such as those that are set out finally in the executed agreement on the 4th of March?

A. Yes, I even took my books of account over to his office so that he might look them over.

Q. And then you and Mr. Gilbert endeavored to determine the value of the different items of community property, did you not? A. We did.

Q. And then you endeavored to—withdraw that.

It was explained to you, was it not, at that time, before the agreement was even drafted, that Mrs. Johnson did not want a half interest in the earned fees?

A. At the beginning I suggested to Mr. Gilbert that it would be very easy to draw up a settlement, that we could have just undivided interest in everything.

Q. You mean give her half and you take half?

A. Each piece of real estate and each piece of personal property, and that any collections from accounts would [13] be divided 50-50, and so on.

Q. Upon future collections?

A. Well, either before or after collections, and an assignment could then be made at the time. That was in our first conference, and then he said he was inclined to think that perhaps Mrs. Johnson wouldn't want that, that she would want separate individual properties, and that was the purpose of

(Testimony of Todd W. Johnson.)
the conference, to determine if we could segregate the individual properties and each take divided interests rather than undivided interests.

Q. Equally divided interests?

A. Yes, equally, and at a later conference that was accomplished.

Q. You mean by "equally divided interests," that she should take these parcels and you should take those parcels but that they should be as nearly equal in value as possible?

A. That is correct.

Q. Sometimes known as a division in kind or a distribution in probate in kind, these distributees will take this property and other distributees will take that property, but they must be equal in value? Distribution in kind, or maybe you don't know what I mean by "distribution in kind."

A. At least our idea was that we would do things fairly and when we ended up each one would have half, although each one would have specific properties rather than [14] undivided interests.

Q. Each would have a half at least in approximate value. A. Yes. [15]

Mr. Mitchell: Now, if the Court please, continuing my argument, objecting to the document which had been offered, * * *. [16]

If the Court holds that the settlement evidenced capital transactions entered into for profit and con-

stituted sales or exchanges between the parties and is not a division, and that the wife had power to dispose of, not merely relinquishes her interest in the community property, then to determine the taxable gains or deductible losses of the respective spouses, the values of the following rights, titles, and interests transferred, received, and exchanged by the husband must be determined, first, the value of his separate title and interest in the joint tenancy property and, second, the value during marriage of his interest in and the value of his rights, powers and personal economic benefits in respect to each parcel of community property, and the cost basis to him—not to the community—of each parcel, and also the value—the Court will also have to determine the values of the following rights, titles, interests, transferred, received and exchanged by the wife, first, the value of her separate title and interest in the joint tenancy property, second, the value of her interest in and her rights, powers and personal economic benefit in respect to each parcel [43] of community property, third, the value of her right to support and maintenance from her husband after February 28, 1935, the time when the year's support expired under the agreement, and fourth, the value of her right to temporary support, the value of her right to costs and attorney's fees from her husband in the event of a divorce action, and fifth, the cost basis to her—not to the community—of each parcel.

Now, that is a big order, if the Court please.

Mr. Johnson: If your Honor please, I think some of the matters mentioned by Mr. Mitchell are not necessary to determine. I think the only thing it is necessary to determine is the cost of the various properties to the community, and the market value of those properties on the date of the property settlement agreement.

The parties themselves settled all of these matters that were mentioned by Mr. Mitchell at arm's length and they were fixed. The testimony that is objected to is my testimony as to the cost to the community of the various assets and the market value of those assets on March 4, 1935, as to the competency, and as to these values and costs, and cost basis being material to the issues in the case.

[44]

Mr. Johnson: Yes, and there is some slight testimony also in connection with these properties.

The Court: We will have that and withhold this ruling.

Mr. Johnson: I have another document, or statement, entitled "Cost to Community and Market Value of Property Received and Liabilities Paid by Todd W. Johnson under Property Settlement Agreement dated March 4, 1935," which I would first like to have marked for identification as Plaintiff's Exhibit No. 3.

The Clerk: Plaintiff's Exhibit 3 for identification.

(The document referred to was marked "Plaintiff's Exhibit No. 3 for identification.")

Mr. Johnson: I would now like to offer Plaintiff's Exhibit 3 for identification into evidence, to have the same effect by stipulation as if Todd W. Johnson had gotten on the stand and testified as to the cost of each one of the properties listed and as to the market value on March 4, 1935, as [50] to each of the properties listed and as to the payment of the income tax liabilities described therein.

Mr. Mitchell: Defendant makes exactly the same objection to this offer as to the offer of Plaintiff's Exhibit 2, and adds to the grounds the following further objections, referring to Plaintiff's Exhibit 3 for identification, under the title "Liabilities Paid by Plaintiff under the Property Settlement Agreement," the objection to the 1934 income taxes assessed in the name of his wife, on the ground that those were community expenses arising out of the receipt of community income, and therefore were personal debts of the husband and were not the personal debts of the wife, and even upon plaintiff's theory should not be taken into consideration. [51]

The Court: That would balance that out.

I think I want to hear all of the evidence so that if my ruling is not satisfactory finally, that the record will be in such shape that it will not have to be tried again, and the entire case then can be decided adversely to my ruling, or the other way, and the Government must put in its objection in order to protect itself on the record. So I think that is the way to proceed. I will overrule the ob- [74] jection, and stating frankly why I am doing it. [75]

TODD W. JOHNSON

recalled as a witness by and in behalf of the plaintiff, having been previously duly sworn, was examined and testified further as follows:

Direct Examination

Mr. Johnson: I would like to give my qualifications as an expert witness on valuation.

For the period 1919 to 1929, I was employed by the Federal Government under the title of Internal Revenue Agent, but actually as an appraiser of estates for federal estate tax purposes. During that 10-year period I appraised the value of estates aggregating several hundred million dollars.

The estate, I would say, consisted principally of real estate, although they also involved closed corporation stocks, listed stocks, and in fact, property of every character.

From 1925 until 1929 I appraised estates in the Los Angeles area which included the city and surrounding vicinity.

From 1929 until 1935 I was engaged in the practice of law, but my practice consisted largely of federal estate taxes and state inheritance tax matters.

In connection with those matters, it was necessary, and I did appraise, estates involving many millions of dollars in Los Angeles and vicinity, and in this particular instance [76] just prior to March 1935, I made a thorough check of the particular properties and sales, rental and sales values in the

(Testimony of Todd W. Johnson.)
vicinity, and I think that I was fairly familiar with the properties at that time.

Mr. Mitchell: You referred to real estate involved in the property settlement agreement?

Mr. Johnson: Not only the real estate, but other types of properties as well.

You may cross examine, Mr. Mitchell.

Cross Examination

By Mr. Mitchell:

Q. Did you ever have occasion to appraise the value of the right to dispose of property or one-half of property by will?

A. I never did, no.

Q. Did you ever have the occasion to appraise the value of a 30-year old married woman's right to support and maintenance from her husband?

A. I did not.

Q. Would you say it is possible to appraise a value upon such a right?

A. I think it would be possible, given certain evidentiary facts in advance, yes.

Q. Age and the amount necessary for her support, you mean?

A. That, and also the earning capacity of the husband [77] during her expectancy, and her ability to support herself, and various factors of that kind that would have to be necessarily taken into consideration.

Q. Did you ever have occasion to appraise the

(Testimony of Todd W. Johnson.)

value of a California married woman's right or her option, statutory option, to set aside her husband's gift of community property if you knew the value of the community property?

A. I never had occasion to attempt to appraise that, no.

Q. Do you feel that such an optional right on the part of a wife is capable of valuation?

A. I don't believe it would be in the manner in which you state it. I think if you were given the proper facts I believe you could.

Q. Have you ever had occasion to appraise the value of a California married man's right and power to pay his debts out of the wife's half of the community property, his personal debts?

A. No, I have not.

Q. Have you ever had occasion to appraise the value of a husband's right to dispose for consideration freely of the wife's half of community personal property?

A. I have never appraised such a right. I don't think it would have any value, but I have never appraised it.

Q. Have you ever had occasion to appraise the value [78] of a husband's exclusive statutory right to manage and control the wife's half of the community property?

A. I have never appraised that right.

Q. Do you believe that the power to use the property is one or the chief essential elements in fixing values?

(Testimony of Todd W. Johnson.)

A. Mr. Mitchell, do you mean the right to use for your own benefit, or the right to use for someone else's benefit?

Q. The right to use for your own benefit.

A. For one's own exclusive benefit without payment of charge or payment of rent?

Q. That is right?

A. Yes, I think it has a valuable right.

Q. You mean by that, if you owned an automobile, but couldn't use it, it would have no value, would it?

A. It might have very much of a value. Someone else might be able to use it at my instance, or for my benefit.

Q. What are the elements of value? What makes property have a value? What is it in property that gives it a value, intrinsic, market, ecenomic value? You can differentiate if you like.

A. The right to use property for your own use or to rent it to someone else for their use, or the right to sell it generally are the things that make value. By value, I mean the ability to sell it.

Q. Now, what makes intrinsic value then, economic [79] value, other than the power to sell it?

A. It is the use that the particular property can be put to.

Q. And if the owner of property has exclusive power to use that property, it has no value to anyone but him, isn't that true, unless he gives it to somebody or gives the use to somebody else?

(Testimony of Todd W. Johnson.)

A. It may have quite a value to someone else if he must pay or account to the other party for the use of that particular property.

Q. Power to dispose of property is one of the very important elements in giving property a value, isn't it, as well as the power to use?

A. It is, but a trustee may be able to dispose of property and yet not be able to use the process for his own benefit at all, so that the power of disposition in such an instance would have no monetary value at all to the trustee.

Mr. Mitchell: I think that is all at the present time.

(Witness excused.)

Mr. Mitchell: These exhibits have now been introduced?

The Clerk: No.

Mr. Mitchell: The Court overruled the Government's objection to their offer.

The Court: They haven't been offered again, Mr. Mitchell. [80]

Mr. Johnson: I will now offer into evidence Plaintiff's Exhibits for identification Nos. 2 and 3.

Mr. Mitchell: I renew my objections on the same grounds.

The Court: They will be received.

The Clerk: Plaintiff's Exhibits 2 and 3 admitted into evidence.

(The documents showing cost to community and market value of property received and liabilities paid by Todd W. Johnson and Esther Jeanne Johnson were received in evidence and marked "Plaintiff's Exhibits 2 and 3, respectively.")

PLAINTIFF'S EXHIBIT No. 2

COST TO COMMUNITY AND MARKET VALUE OF ASSETS RECEIVED BY ESTHER JEANNE JOHNSON UNDER PROPERTY SETTLEMENT AGREEMENT DATED MARCH 4, 1935.

	Cost to Community	Market Value March 4, 1935
1. Real Estate described in Article 1 of Property Settlement Agreement	39,284.61	35,000.00
2. Real Estate described in Article 2 of Property Settlement Agreement	19,496.50	25,000.00
3. Furniture, furnishings and equipment described in Article 3 of Property Settlement Agreement	15,000.00	10,000.00
4. Packard automobile described in Article 4 of Property Settlement Agreement	2,180.17	2,000.00
5. Jewelry described in Article 5 of Property Settlement Agreement	3,000.00	2,000.00
	78,961.28	74,000.00
Less depreciation items 2 and 4	1,740.84	nil
	77,220.44	74,000.00
Cash paid to Esther Jeanne Johnson his then wife by plaintiff as provided in Article 6 (net-cost) of Property Settlement Agreement	6,000.00	6,000.00
Total	$83,220.44	$80,000.00

[Endorsed]: Filed 9-18-1941.

PLAINTIFF'S EXHIBIT No. 3

COST TO COMMUNITY AND MARKET VALUE OF PROPERTY RECEIVED AND LIABILITIES PAID BY TODD W. JOHNSON UNDER PROPERTY SETTLEMENT AGREEMENT DATED MARCH 4, 1935.

		Cost to Community	Market Value March 4, 1935
1.	Real Estate described in Article 8(a) of Property Settlement Agreement	3,000.000	1,500.00
2.	Real Estate described in Article 8(b) of Property Settlement Agreement	1,845.28	500.00
3.	Real Estate described in Article 8(c) of Property Settlement Agreement	31,355.08	30,000.00
4.	300 shares Citizens Bank described in Article 9 of Property Settlement Agreement	8,095.25	6,000.00
5.	200 shares Dunhill International described in Article 9 of Property Settlement Agreement	4,322.50	1,000.00
6.	Auburn automobile described in Article 9 of Property Settlement Agreement (Cost estimated)	1,500.00	1,000.00
7.	Cash in Banks as set forth in Article 9 of Property Settlement Agreement	6,350.96	6,350.96
8.	Accounts receivable for legal fees due plaintiff, collected in 1935, as set forth in Property Settlement Agreement	No Cost	31,958.67
9.	Johnson and Johnston—accounts receivable collected in 1935, as set forth in Property Settlement Agreement	No Cost	20,069.78
		56,469.07	98,379.41
	Depreciation on items 3 and 6	1,850.00	
		54,619.07	
	Liabilities paid by Plaintiff under Property Settlement Agreement		
	1934 Income Tax of plaintiff paid by plaintiff	5,082.78	5,082.78
	1934 Income Tax of Esther Jeanne Johnson paid by plaintiff	5,082.78	5,082.78

Cost to Community and Market Value of Property Received and Liabilities Paid by Todd W. Johnson Under Property Settlement Agreement Dated March 4, 1935—(Continued.)

	Cost to Community	Market Value March 4, 1935
1935 Income Tax of plaintiff paid by plaintiff	3,118.95	3,118.95
1935 Income Tax of Esther Jeanne Johnson paid by plaintiff	3,118.95	3,118.95
	16,403.46	16,403.46
Difference	38,215.61	81,975.95

[Endorsed]: Filed 9-18-1941.

Mr. Mitchell: May it be clear for the record that the defendant is stipulating that the witness, Mr. Johnson, the plaintiff, would testify as set forth in the exhibits, and call the Court's attention to the fact that the costs as set forth in the first column in each exhibit, Plaintiff's Exhibits 2 and 3, are the costs of certain tangible properties to the community, the community cost, not Mr. Johnson's cost nor Mrs. Johnson's cost basis for the community cost basis.

The Court: Mr. Mitchell, make that just a little clearer, because evidently you have a distinction there in mind. If these properties were paid for out of community funds, then it is community property.

Mr. Mitchell: That is true.

The Court: And the cost is community cost.

Mr. Mitchell: Correct. [81]

So as to explain my reason for that limitation, it is the Government's contention that Mr. Johnson's cost basis is much greater than Mrs. Johnson's cost basis, because Mr. Johnson's interest in community property is much greater than Mrs. Johnson's interest in community property, and that Mrs. Johnson gave up certain rights, statutory rights, to support and so on, that have a value, and which enter into her cost basis.

In other words, these figures are valueless insofar as determining the cost basis and market value of Mrs. Johnson's interest, or insofar as determining the cost basis of Mr. Johnson's interest or the market value of his interest at the time of the agreement because of the great difficulty in the value of his interest and the value of her interest.

[82]

TODD W. JOHNSON

recalled as a witness by and in behalf of the Government, having been previously duly sworn, was examined and testified further as follows:

Mr. Johnson: Before you begin your cross examination, Mr. Mitchell, may I ask the Court if my testimony is as an adverse witness for the defendant, may it also be regarded as my direct testimony for the plaintiff.

The Court: Yes.

(Testimony of Todd W. Johnson.)

Cross Examination

By Mr. Mitchell:

Q. Did you receive rents from the Pico property for one year in accordance with Paragraph 7 of the agreement [83] amounting to during that year $2,179.74?

A. I did. I might say that in originally preparing that statement, that I considered that the bills paid, current bills, were somewhat more than that and I did not take that item into consideration for that reason.

Q. Mr. Johnson, referring again to Plaintiff's Exhibit 3, the last item entitled "1935 Income Tax of Esther Jeanne Johnson paid by Plaintiff," why do you put that in two columns? You have a column here of income taxes, the cost to community of income taxes paid. Is that for comparing the column to the totals of the column?

A. It is for the purpose of comparing market values with cost values. That would be in the nature of an assumption of a liability and in the purchase of a property, so that if you assume certain debts you would get that much less.

Q. Then you are not testifying that the left-hand column following the 1934 and 1935 taxes paid by you are cost to the community, are you? [84]

A. No. This is Exhibit 3. The actual book costs of the property received was $54,619.07, less debts of $16,403.46, which I assumed, so that actually the difference would be $38,215.61.

(Testimony of Todd W. Johnson.)

Likewise, the market value of the property received was $98,379.41, and I assumed $16,403.46 debts, so that I received a net property above debts of $81,975.95. That was put there for comparison of what I got out of the property settlement as compared to what my wife received out of it.

Q. Now, Mr. Johnson, prior to the time the property settlement agreement and your negotiations with Mr. Gilbert, about which you testified this morning, did Mr. Gilbert at that time promise that when he drafted the divorce complaint he would not ask you for any alimony, temporary or permanent, or for costs or attorney's fees, other than what you agreed to in the property settlement agreement? [85]

The Witness: Well, I don't remember his promising me that exact thing, Mr. Mitchell. It was just understood that there wasn't any alimony involved. [86]

Q. Now, about this item 8 in Plaintiff's Exhibit 3. Item 8 reads, "Accounts Receivable for Legal Fees due Plaintiff, Collected in 1935, as set forth in Property Settlement Agreement."

That means collected after March 4, 1935, does it not?

A. Between March 4, 1935, and December 31, 1935. [88]

Q. As of March 4, 1935, how were you able to estimate that exactly one-half of earned but uncollected accounts receivable of the partnership, that

(Testimony of Todd W. Johnson.)
is, your interest, one-half of your interest, was $20,069.78?

A. That represented the accounts receivable which were due and were payable for work finished.

Q. Gross? A. Yes, gross.

Q. You didn't know then what your net profit for the year would be, did you?

A. Not exactly, no.

Q. You didn't know what the expenses would be the bal- [89] ance of the 10 months of the year?

A. I didn't know exactly what they would be. I could have made a pretty close approximation.

Q. You didn't know what the gross assets would be for the balance of the year?

A. That is true. [90]

Q. What was the age of your wife as of the date of the agreement?

A. I believe 30 years.

Q. 30 years old? A. Yes. [91]

Mr. Johnson: Mr. Gilbert informed me that he wouldn't contend in our negotiations that my wife was not capable of earning her own living, that he would admit that for the purpose of our discussions, and from the very beginning that was not brought up again, excepting it was understood that there would be no claim other than the property settlement agreement itself.

Mr. Mitchell: No claim for alimony you mean.

Mr. Johnson: No other claim of alimony or any other kind, excepting as shown in the property settlement agreement. [94]

(Testimony of Todd W. Johnson.)

Mr. Johnson: Your Honor, at this time I would like to make a motion, and in support of that motion——

Mr. Johnson: The motion I would like to make would be to amend the prayer in my complaint to ask for a refund of $7,148.11——

The Court (Interrupting): $7,148.11.

Mr. Johnson (Continuing): ——plus interest as allowed by law in lieu of the prayer as it now stands, which asks for a refund of $3,828.15, plus interest as allowed by law.

The increased amount of refund represents the exact amount of deficiency income tax which the Commissioner pro- [133] posed to assess against me and which was paid, partly in cash and partly by credit. [134]

I don't have any sound reasons for resisting counsel's motion. So far as his theory is concerned as expressed today, it is the very theory that I thought he was relying on all the time as an alternative theory to the gift theory, and I don't see any difference so far as the general theory is concerned, but my only thought is that he now has figured out under the same theory that he is entitled to a larger refund than he was before.

The Court: The amendment will be allowed. [145]

The Court: Do you rest, Mr. Johnson?

Mr. Johnson: Yes, I rest.

Mr. Mitchell: If the Court please, for the record

(Testimony of Todd W. Johnson.)
I would like to make a motion at this time to strike out all testimony and evidence relating to values, both the cost basis and values, upon all of the grounds that I stated in support of my objection to the introduction of that very testimony. [147]

The Court: The motion will be denied. An exception allowed the Government.

Mr. Mitchell: Now, Mr. Johnson, as attorney for your- [150] self will you stipulate that Mrs. Johnson filed no gift tax return reporting any gifts received from you or any gifts from her to you in the year 1935?

Mr. Johnson: I will.

Mr. Mitchell: Will you also stipulate that you filed no gift tax return and paid no gift tax upon any gifts by you to Mrs. Johnson in the year 1935 or by virtue of any gifts from her to you in the year 1935?

Mr. Johnson: I will.

Mr. Mitchell: Will you stipulate that no children were born of the marriage with Mrs. Esther Jeanne Johnson?

Mr. Johnson: I will. [151]

Mr. Mitchell: Mr. Johnson has already been sworn and he is again called as an adverse witness under Rule 43, Section B.

Direct Examination

By Mr. Mitchell:

Q. Mr. Johnson, one paragraph of the agree-

(Testimony of Todd W. Johnson.)

ment of March 4, 1935—I refer to paragraph 13—reads as follows: "It is further agreed that this agreement shall be in lieu of all other compensation or claims of any kind in favor of either party against the other * * *."

Since the execution of that agreement, has Mrs. Johnson ever made any claim to you for support or alimony or any other claim at all?

A. No, she has not.

I might add, Mr. Mitchell, that I have been informed that she fared very badly financially in the management of her properties, and that an attorney was consulted by her with the idea of determining whether or not she could get any more out of me. That is the only information that I have. She herself to me direct has never made a claim.

Q. Has any agent on her behalf made a claim against you? [152]

A. The attorney told me that he had been approached, and he had informed her that she had no standing legally.

Q. So that no claim was made against you?

A. Well, no, not actually to me by her.

Q. Or by any agent?

A. By her filing suit or anything like that. That is what happened.

Q. I have here two quit claim deeds, Mr. Johnson, from Esther Jeanne Johnson to yourself, which are duly recorded, each is dated March 4, 1935, and ask whether these—they are signed "Esther Jeanne

(Testimony of Todd W. Johnson.)

Johnson" and duly acknowledged—were delivered to you at about the time they were signed.

A. They were at the time they were signed.

Mr. Mitchell: If the Court please, I think counsel will stipulate that the properties described in these quit claim deeds were the three parcels of real estate described in paragraph 8 of the property settlement agreement, paragraphs 8(a), 8(b), and 8(c).

Is that correct, Mr. Johnson?

The Witness: They are the same properties described in the property settlement agreement, but I can't tell you under which paragraph, which came to me. [153]

Mr. Mitchell: One deed covers Lots 21 and 22 of Tract No. 6073, as recorded in Book 63, page 13 of Maps. This describes one parcel of property and recites that it was held in the name of Todd W. Johnson. The portion that I desire to read in the record from this schedule is as follows. (It is in parentheses):

> "(This release is made to carry out the mutual agreement entered into in that the said property hereinafter referred to shall be and become the sole and separate property of Todd W. Johnson.)"

The other deed covers two parcels of property, the first Lot 49, Tract 8025, and the second parcel being Lots 142 and 161, 162, 163, 164, and 165 or Tract 5070. Following the description is the following paragraph which reads as follows:

(Testimony of Todd W. Johnson.)

"This conveyance is made by Esther Jeanne Johnson (also known as E. Jeanne Johnson) to Todd W. Johnson to carry out the mutual agreement entered into in that the said property hereinabove referred to shall be and become the sole and separate property of said Todd W. [154] Johnson." [155]

Mr. Mitchell: If the Court please, the defendant desires to introduce a certified copy of the income tax return for 1935, filed by Todd W. Johnson, and ask that it be marked Defendant's Exhibit A.

The Clerk: Defendant's Exhibit A.

(The income tax return referred to was received in evidence and marked "Defendant's Exhibit A.")

DEFENDANT'S EXHIBIT A

United States of America
Treasury Department
Washington

March 10, 1941

Pursuant to the provisions of Section 661, Chapter 17, Title 28 of the United States Code (Section 882 of the Revised Statutes of the United States), I hereby certify that the annexed is a true copy of Individual Income Tax Return for 1935, (with rider

(Testimony of Todd W. Johnson.)

attached), filed by Todd W. Johnson, Los Angeles, California, filed in this Department.

In witness whereof, I have hereunto set my hand, and caused the seal of the Treasury Department to be affixed, on the day and year first above written.

By direction of the Secretary of the Treasury:

F. A. BIRGFELD

Chief Clerk, Treasury Department.

WHB JWB S S F J P W H

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FILED

INDIVIDUAL INCOME TAX RETURN

FOR NET INCOMES FROM SALARIES OR WAGES OF MORE THAN $3,000 AND INCOMES FROM BUSINESS, PROFESSION, TRADE, OR SALE OF PROPERTY

For Calendar Year 1935

or fiscal year beginning _____, 1935, and ended _____, 1936

File This Return Not Later Than the 15th Day of the Third Month Following the Close of the Taxable Year

Do Not Write in These Spaces

Div. Co. 1469

Serial Number 2000046

District _____

(Collector's Stamp)

Cash Check M. O.

First Payment $ 7.73

PRINT NAME AND ADDRESS PLAINLY BELOW

TODD W. JOHNSON
(Name) (If husband and wife, if this is a joint return)
433 South Spring Street,
(Street and number, or rural route)
Los Angeles, California
(Post office) (County) (State)

Tax ... 7.84.89
Penalty -
Interest - 1025.84
Total 8.847.73
Bank RAR 7/23/36
Audited by
Date 2-25/37
Entered
Index
Page
Line

1. State whether you are (a) a citizen of the United States, or (b) a resident alien. Citizen
2. If you filed a return for the preceding year, to what collector did you make it? 6th Cal
3. Were you married and living with husband or wife during year? Yes
4. Is this a joint return of husband and wife? Yes
5. State name of husband or wife for whom separate return was made and the Collector's office in which it was filed. Mrs. Ethel Johnson, 6th California
6. If married, were you during your taxable year supporting in your household one or more persons (or only yourself or you)? Yes
7. Are you supporting dependent persons (other than husband or wife) under 18 years of age or incapable of self-support (omitted their child support from you during your taxable year)? None

8. If your answer in response to question 5, 6, or 7 is affirmative, give name, place, date and nature of change _____
9. State whether your books are kept on cash or accrual basis. Cash
10. State principal occupation or profession, giving kind of business, trade, or profession carried on, firm, etc., in full. Attorney-at-Law
11. Did you transfer to or receive from any one person money or property in excess of $5,000, during the calendar year 1935, without an adequate and full consideration in money or money's worth? No
If so, did you file a gift tax return on Form 709 or an information return on Form 710? _____
12. Did you receive dividends on stock owned in your name but belonging to your wife or minor children? No
13. Did you purchase or contract for any real estate or similar property for sale or exchange, or advise you as to the preparation of this return, during this return for year? No
If so, name and address of such person or persons; a separate and distinct of the contracts or advice was and the items or schedules in respect of which the advice was received. If this return was prepared by a person other than yourself, state the name of the person or persons who then yourself, state the name of the information reported in this return and the source which it was furnished to or obtained by such person or persons _____

ATTACH REMITTANCE HERE

INCOME

	Amount received	Deductions allowed
1. Salaries, Wages, Commissions, Fees, etc. (State name and address of employer)	$ 7,312	$
2. Net profit (or Loss) from Business or Profession. (From Schedule A)		
3. Interest on Bank Deposits, Notes, Corporation Bonds, etc. (except interest on tax-free covenant bonds) (State kind of business)	12	13
4. Interest on Tax-free Covenant Bonds Upon Which such a Tax was Paid at Source		
5. Income (or Loss) from Partnerships, Syndicates, Pools, etc. (Name and address of each)	12	13
6. Income from Fiduciaries. (Furnish name and address)		
7. Rents and Royalties. (From Schedule B)		
8. Capital Gain (or Loss). (From Schedule C)		
9. Taxable Interest on Liberty Bonds, etc. (From Schedule D, Line (g))		
10. Dividends on Stock of: (a) Domestic Corporations subject to taxation under Title I of 1934 Act		
(b) Domestic Corporations not subject to taxation under Title I of 1934 Act		
(c) Foreign Corporations		
11. Other Income. (State nature) (Use separate schedule, if necessary)		
12. TOTAL INCOME IN ITEMS 1 TO 11		

L. SURVEY REVIEW
SEP 6 1940
By: H. B. Ripy

DEDUCTIONS

13. Interest Paid. (Explain in Schedule F)	none	$
14. Taxes Paid. (Explain in Schedule F)		
15. Losses by Fire, Storm, etc. (Explain in table at foot of page F)		
16. Bad Debts (including bonds determined to be worthless during taxable year) (Explain in Schedule F)		
17. Contributions. (Explain in Schedule F)		
18. Other Deductions Authorized by Law (including stock determined to be worthless during taxable year). (Explain in Schedule F)		
19. TOTAL DEDUCTIONS IN ITEMS 13 TO 18		
20. NET INCOME (Item 12 minus Item 19)		

COMPUTATION OF TAX (See Instruction 23)

21. Net income (Item 20 above)			$	541	16
22. Less: Personal exemption	$ 1,200	00			
23. Credit for Dependents (Explain in Schedule F)			1	000	
24. Balance (Surtax net income)			$	541	16
25. Less: Interest on Liberty bonds, etc. (Item 9)	$				
26. Dividends. (Item 10 (c))	27	50			
27. Earned Income credit. (See Instruction 27)	1,400	00	1	617	50
28. Balance subject to normal tax			$	27	66

29. Normal tax (4% of Item 28)		
30. Surtax on Item 24 (see Instruction 23)		
31. Total tax (Item 29 plus Item 30)	$	
32. Less: Income tax paid at source (2% of Item 4)		
33. Income tax paid to a foreign country or U. S. possession		
34. Balance of Tax. (Item 31 minus Items 32 and 33)	$	

AFFIDAVIT (See Instruction 27)

I/we swear (or affirm) that this return (including its accompanying schedules and statements, if any) has been examined by me/us, and to the best of my/our knowledge and belief is a true, correct, and complete return, made in good faith, for the taxable year stated, pursuant to the Revenue Act of 1934 and the Regulations issued thereunder.

Sworn to and subscribed by Todd W. Johnson before Todd W. Johnson

me this 13th day of January, 1936

L. C. Johnson

NOTARIAL SEAL

A RETURN MADE BY AN AGENT MUST BE ACCOMPANIED BY POWER OF ATTORNEY (See Inst. 27)

AFFIDAVIT (See Instruction 27)

I/we swear (or affirm) that I/we prepared this return for the person or persons named herein and that the return (including its accompanying schedules and statements, if any) is a true, correct, and complete statement of all the information respecting the income tax liability of the person or persons for whom this return has been prepared of which I/we have any knowledge.

Sworn to and subscribed before me this _____ day of _____, 193 .

Todd W. Johnson

NOTARIAL SEAL

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a-1

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Other Business Deductions			
10. Salaries not included on [illegible] and deduct compensation			
11. Interest on business indebtedness to others 1/2	627	41	
12. Taxes on business and business property 1/2	1,562	88	
13. Losses (explain in table at foot of page)			
14. Bad debts arising from sales or services 1/2	2,979	10	
15. Depreciation, obsolescence, and depletion (Explain in table provided at foot of page) 1/2	933	75	
16. Rent, repairs, and other expenses (Itemize below or on separate sheet)	1,233	68	
17. TOTAL (Lines 10 to 16)	$ 7,332	22	7,332 22
18. TOTAL DEDUCTIONS (Line 9 plus Line 17)			
19. NET PROFIT (or Loss) (Line 1 minus Line 18) (Enter on Item 2)			$ 26,641 1.

Explanation of deductions claimed on Lines 6 and 16: 1/2 Office Expense $ 263.12, Repairs 1/2 $46.59, Insurance 1/2 $636.10
Miscellaneous Expense 1/2 $288.76

SCHEDULE B—INCOME FROM RENTS AND ROYALTIES (See Instruction 7)

1. Kind of Property	2. Amount Received	3. Cost or Value as of March 1, 1913, If Received Otherwise	4. Depreciation (Explain in table at foot of page)	5. Repairs	6. Other Expenses (Itemize below)	7. Net Profit (Enter as Item 7)
	$	$	$	$	$	$

Explanation of deductions claimed in Column 6

SCHEDULE C—CAPITAL GAINS AND LOSSES (From Sales or Exchanges Only) (See Instruction 8)

Description of Property (If Listed Stock, Number of Shares)	2. Date Acquired	3. Date Sold or Exchanged	4. Gross Sales Price (Contract price)	5. Cost or March 1, 1913, Value If Acquired Before That Date (Indicate basis)	6. Cost or Improvements Subsequent to Acquisition or March 1, 1913	7. Depreciation Allowed (or Allowable) Since Acquisition or March 1, 1913 (Furnish details)	8. Date of Loss	9. Per Cent of Gain or Loss to be Taken into Account	10. Gain or Loss to be Taken into Account	
									a. Gains	b. Losses
(a) 1 year or less	Mo. Day Year	Mo. Day Year	$	$	$	$		100	$	$
(b) Over 1 year but not over 2 years								80		
(c) Over 2 years but not over 5 years								60		
(d) Over 5 years but not over 10 years								40		
(e) Over 10 years								30		

(f) Total Gains and Losses (Enter net amount as Item 8) (Capital losses are allowable only to the extent of $2,000 plus capital gains) $ $

A registered sale or exchange of capital assets which involves a relation, if customary, for transactions coming within each of the 5 periods, and transfer gains and losses for each period to Column 10 above. List of property sold to be entered in Column 1 if a loss is claimed in Column 6. (If Power of or business relationship, if any, of purchaser [illegible] or property was acquired [illegible] exchange of stock should be reported in detail, including name and address of corporation, class of stock, number of shares, capital changes affecting basis since distribution, other pertinent information, and dates.)

SCHEDULE D—INTEREST ON LIBERTY BONDS AND OTHER OBLIGATIONS OR SECURITIES (See Instruction 9)

1. Obligations or Securities	2. Amount Owned at End of Year	3. Interest Received or Accrued During the Year	4. Period Amount Exempt from Taxation	5. Amount Owned in Excess of Exemption	6. Interest on Amount in Excess of Exemption
(a) Obligations of a State, Territory, or political subdivision thereof, or the District of Columbia, or United States possessions	$	$	All	XXXXXX	XXXXXX
(b) Obligations issued under Federal Farm Loan Act, or under such Act as amended			All	XXXXXX	XXXXXX
Liberty 3½% Bonds and other obligations of United States issued or before September 1, 1917			A	XXXXXX	XXXXXX
Treasury Notes, Treasury Bills, and Treasury Certificates of Indebtedness			All	XXXXXX	XXXXXX
Liberty 4% and 4½% Bonds; U.S. Savings Bonds; Treasury Bonds. Obligations of instrumentalities of the United States (other than obligations to be reported in (b) above)			$5,000	$	$
			None		
(c) TOTAL (enter total of column 6 as Item 9)					$

SCHEDULE E—INCOME FROM DIVIDENDS

Name all dividends received during the year, stating amounts and name and address of corporations declaring the dividends

[illegible] Beaumont, California

SCHEDULE F—EXPLANATION OF DEDUCTIONS CLAIMED IN ITEMS 1, 13, 14, 16, 17, AND 18, AND CREDIT CLAIMED IN ITEM 23

[illegible] depreciation 1/2 1,7[illegible] 1/2 ad[illegible]
[illegible] repairs 1/2 1,1[illegible] [illegible]
[illegible] insurance 1/2 1,7[illegible] [illegible]
[illegible] misc. expense 1/2 77[illegible] [illegible]

EXPLANATION OF DEDUCTION FOR DEPRECIATION CLAIMED IN SCHEDULES A AND B

1. Kind of Property (If building, state material of which constructed)	2. Date Acquired	3. Cost or March 1, 1913, Value or Acquired Prior to That Date (Indicate basis)	4. Amount Fully Depreciated in Use as of End of Year	5. Depreciation Allowed (or Allowable) in Prior Years	6. Remaining Cost or Other Basis to be Recovered	7. Life (Years) in Accordance with Depreciation	8. Estimated Remaining Life from Beginning of Year	9. Depreciation Allowed This Year
1/2 Garage	1/1/[illegible]	[illegible]					7	75
1/2 Store [illegible]	1933	$ 1,[illegible]	$	$	$ 1,[illegible]		22	$
1/2 Store [illegible]	1934	2,[illegible]					23	
1/2 Farm Bldg.	1936	7,000	00					

EXPLANATION OF DEDUCTION FOR LOSSES BY FIRE, STORM, ETC., CLAIMED IN SCHEDULE A AND IN ITEM 15

1. Kind of Property	2. Date Acquired	3. Cost	4. Depreciation Subsequently	5. Depreciation Allowable Since Acquisition	6. Insurance and Salvage Value	7. Deductible Loss
		$	$	$	$	$

62

A-2

120

(Testimony of Todd W. Johnson.)

Rider

An interlocutory decree, granting divorce and approving property settlement between Todd W. Johnson and Esther Jeanne Johnson, husband and wife, was made by the Superior Court, Los Angeles County, California, on March 29, 1935. Under the California Law the final decree can be obtained any time after March 29, 1936, if the parties do not live together as husband and wife prior to said time. Until or unless a final decree is made by said Superior Court, the parties are husband and wife the same as if no interlocutory decree had been made.

Therefore, the returns of the parties are made as husband and wife, but a personal exemption of only $1,000.00 each is claimed, total exemption—$2,000.00, instead of claiming $2,500.00 personal exemption, which is allowable to a husband and wife who live together during all of the calendar year.

[Endorsed]: Filed 9/17/41.

Mr. Mitchell: And also the information income tax return filed by the partnership of Johnson and Johnston for the year 1935, and ask that it be marked Defendant's Exhibit B.

The Clerk: Defendant's Exhibit B.

(The income tax return referred to was received in evidence and marked "Defendant's Exhibit B.")

(Testimony of Todd W. Johnson.)

DEFENDANT'S EXHIBIT B

United States of America
Treasury Department
Washington

March 10, 1941

Pursuant to the provisions of Section 661, Chapter 17, Title 28 of the United States Code (Section 882 of the Revised Statutes of the United States), I hereby certify that the annexed is a true copy of Partnership Return of Income for 1935, filed by Johnson and Johnston, Los Angeles, California, filed in this Department.

In Witness Whereof, I have hereunto set my hand, and caused the seal of the Treasury Department to be affixed, on the day and year first above written.

By direction of the Secretary of the Treasury.
F. A. BIRGFELD
Chief Clerk, Treasury Department.

WHB JWB S S F J P W H
umb

[Endorsed]: Filed 9/17/40

REVISED
SECTION E-2
BY A F BR JAN
DATE MAY 13 1938

R&R 6/15/38 Conf 2/2/39
T.S. 6/15/38

Expert

PARTNERSHIP RETURN OF INCOME

(TO BE FILED ALSO BY SYNDICATES, POOLS, JOINT VENTURES, ETC.)

For Calendar Year 1935

Or Fiscal Year beginning ..., 1935, and ended ..., 1936

File This Return Not Later Than the Fifteenth Day of the Third Month Following the Close of the Taxable Year

File No. 966

Serial Number 9700433

District: 8-Calif

(Do not Remember)

PRINT PLAINLY NAME AND BUSINESS ADDRESS OF THE ORGANIZATION

JOHNSON & JOHNSON
(Name)
433 South Spring Street.
(Street and number)
Los Angeles, California
(Post Office and State)

Business or Profession: Attorneys at Law

Nature of Organization: Partnership
(Partnership, Syndicate, Pool, Joint Venture, etc.)

Date of Organization: June 1st, 1933

1. Did any person or persons other than the organization receive payment of any question or matter affecting his, their or its relation to the preparation of this return, actually prepare the return for the organization? ... If so, give the name and address of such person or persons or if none the basis and extent of the assistance or advice rendered by the organization and the fee charged for such assistance or advice was reserved. If this return was actually prepared ... (Answer "Yes" or "No") Yes

2. Did the organization make a return of information on Form 1098 and 1099 (see Instruction 21) for the calendar year 1935? (Answer "Yes" or "No")

GROSS INCOME

1. Gross Receipts from Business or Profession		1 42 652 72	
2. Less Cost of Goods Sold			
(a) Inventory at beginning of year	$		
(b) Merchandise bought for sale			
(c) Cost of labor, supplies, etc. (From Schedule A)			
(d) Total of lines (a), (b), and (c)	$		
(e) Less inventory at end of year			
3. Gross Profit from Business or Profession (Item 1 minus Item 2)	$		
4. Income (or loss) from Other Partnerships, Syndicates, Pools, etc. (State separately name and address and amount)			
5. Interest on Bank Deposits, Notes, Corporation Bonds, etc. (except interest on tax-free covenant bonds		1 38	82
6. Interest on Tax-free Covenant Bonds upon which a Tax was Paid at Source			
7. Rents			
8. Royalties			
9. Capital Gain (or loss). (From Schedule B)			
10. Dividends on Stock of			
(a) Domestic Corporations subject to taxation under Title I of Revenue Act of 1935			
(b) Domestic Corporations not subject to taxation under Title I of Revenue Act of 1934			
(c) Foreign Corporations			
11. Other Income (state nature of income):			
(a)			
(b)			
12. TOTAL INCOME (Items 3 to 11)			42 653 82

DEDUCTIONS

13 Salaries of Employees. (Do not include officers or partners or members)	4 228 40	
14 Rent on Business Property	1 960 00	
15. Repairs. (From Schedule C)		
16 Interest on Indebtedness	45 00	
17 Taxes paid. (From Schedule D)	14 03	
18 Losses by Fire, Storm, etc. (From Schedule E)		
19. Bad debts (from schedule F; also bonds determined to be worthless during taxable year. (Explain on schedule)		
20 Charitable Contributions. (Explain on separate schedule)		
21. Depreciation (resulting from ordinary wear and tear) (From Schedule G)	900 00	
22 Other Deductions Authorized by Law (including stock determined to be worthless during taxable year (attach letter from corporation) Office Expense $1,274.94 ...es and Subscriptions $1,437.94	2 711 98	
23. TOTAL DEDUCTIONS (Items 13 to 22)		9 696 33
24 NET INCOME (Item 12 minus Item 23)		32 956 49

PARTNERS' OR MEMBERS' SHARES OF INCOME AND CREDITS
(See Instruction 22)

(1) Name and Address of Each Partner or Member (Designate incompetent when, if any) Note—Where return of partner or member is filed in another collection district, specify district	(2) Per Cent of Net Income	(3) Distributive Item (See Above)	(4) Earned Income	(5) Balance of Net Income (Item 24 Minus Items 3 and 4) Apportioned as per Item 2	(6) Income Tax Paid at Source (Item 5)	(7) Income Tax Paid (Collector District Number)
(a) Todd W. Johnson		$ 24,716 61	$	$	$	$
(b) Philip D. Johnston		8,239 88				
(c)						
(d)						
(e)						
(f)						
(g)						
TOTALS		$	$	$	$	$

65

133

	Amount	Items	Amount
			$
		Total (enter as Item 2 (c))	$

SCHEDULE B—CAPITAL GAINS AND LOSSES (FROM SALES OR EXCHANGES ONLY) (See Instruction 6)

1. Description of Property (Enter Kind and Number of Shares)	2. Date Acquired	3. Date Sold or Exchanged	4. Gross Sale Price (Cash or Value)	5. Cost or Other Basis (If Acquired Before March 1, 1913, Value as of March 1, 1913)	6. Cost or Other Basis (If Acquired Before March 1, 1913, Value as of March 1, 1913)	7. Depreciation Allowed (or Allowable) Since Acquisition but not Earlier than March 1, 1913 (See Instruction 7)	8. Gain or Loss	9. Per-centage of Gain or Loss to be Taken (See Instruction 8)	10. Gain or Loss to be Taken (See Instruction 8)	
									a. Gains	b. Losses
(a) 1 year or less	Mo. Day Year	Mo. Day Year	$	$	$	$	$	100	$	$
(b) Over 1 year but not over 2 years								80		
(c) Over 2 years but not over 5 years								60		
(d) Over 5 years but not over 10 years								40		
(e) Over 10 years								30		

(f) Total Gains and Losses (Enter net amount as Item 6): (Capital losses are allowable only to the extent of $2,000 plus capital gains) $ $

The reporting above of exchanges of capital assets entails corporate schedule, if necessary, for transactions coming within each of the 5 periods, and transfer gains and losses for each period to the column at above. (Cost of property must be reported in column 5 of a form as required in column 4.

For basis of property acquired after February 28, 1913, see Section 113(a) (5), of the Revenue Act of 1924.

State (1) how and from whom property was acquired ..... (2) Personal or business relationship.

If any, of purchaser to partnership in any member thereof

If any sale or exchange of stock should be reported in detail, including name and address of corporation, class of stock, number of shares, capital changes affecting basis (stock dividends, other nontaxable dividends, stock rights, etc.)

SCHEDULE C—COST OF REPAIRS (See Instruction 15)

1 Items	2 Amount (Enter as Item 11)
	$

SCHEDULE D—TAXES PAID (See Instruction 17)

1 Items	2 Amount (Enter as Item 12)
County, Texas	$ 14 03

SCHEDULE E—EXPLANATION OF DEDUCTION FOR LOSSES BY FIRE, STORM, ETC. (See Instruction 14)

1. Kind of Property	2. Date Acquired	3. Cost	4. Subsequent Improvements	5. Depreciation Allowed or Allowable	6. Insurance Paid	7. Deductible Loss (Enter as Item 13)
		$	$	$	$	$

State how property was acquired

SCHEDULE F—EXPLANATION OF DEDUCTION FOR BAD DEBTS (See Instruction 19)

	Year	Net Income	Charged on Account	Bad Debts
(a)	1932	$		$
(b)	1933			
(c)	1934			
(d)	1935			

SCHEDULE G—EXPLANATION OF DEDUCTION FOR DEPRECIATION (See Instruction 21)

1. Kind of Property (If building, state material of which constructed)	2. Date Acquired	3. Cost or March 1, 1913, Value if Acquired Prior to that Date (Indicate basis)	4. Amts Fully Depreciated in Prior Yrs	5. Depreciation Allowed or Allowable in Prior Years	6. Remaining Cost or Other Basis to be Recovered	7. Life Used in Acct'g Purposes	8. Estimated Remaining Life in Acct'g Purposes	9. Depreciation Allowed this Year	
Auto	6/1/33	$ 2,637 69	$	$ 1,044 07	Sold 10/31/35	-		$ 543	82
Furn. & Fix.		1,894 06		231 88		7½		265	40
								738	92

SCHEDULE H—NONTAXABLE OBLIGATIONS, LIBERTY BONDS, ETC. (See Instruction 26)

1. Obligations or Securities	2 Amount Owned at End of Year	3 Interest Received on Same during Year
(a) Obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia, or U. S. possessions	$	$
(b) Obligations issued under the provisions of the Federal Farm Loan Act, or under such act as amended		
(c) Liberty 3½% Bonds and other obligations of United States issued on or before September 1, 1917		
(d) Treasury notes, Treasury bills, and Treasury certificates of indebtedness		
(e) Liberty 4% and 4½% Bonds, U. S. Savings Bonds, and Treasury Bonds		
(f) Obligations of instrumentalities of the United States (other than obligations to be reported in (b) above)		

SCHEDULE I—INCOME FROM DIVIDENDS

Itemize all dividends received during the year, stating amounts and names and addresses of corporations declaring the dividends

AFFIDAVIT (See Instruction 30)

I swear (or affirm) that this return (including its accompanying schedules and statements, if any) has been examined by me, and, to the best of my knowledge and belief, is a true, correct, and complete return, made in good faith, for the accounting period stated, pursuant to the Revenue Act of 1934 and the Regulations issued thereunder.

Sworn to and subscribed before me this 16th day of January, 1936

Phillip D. Johnston
(Signature)

L. L. Johnson
(Signature of officer administering oath)

Notary Public
(Title)

4139 S. Spring St.
(Address of taxpayer or claimant)

INTERNAL REVENUE SEAL

AFFIDAVIT (See Instruction 30)

I/we swear (or affirm) that I/we prepared this return for the organization named herein and that the return (including its accompanying schedules and statements, if any) is a true, correct, and complete statement of all the information respecting the income tax liability of the person for whom this return has been prepared of which I/we have any knowledge.

Sworn to and subscribed before me this ..... day of ....., 193

(Signature of person preparing the return)

(Signature of officer administering oath)

(Title)

(Signature of taxpayer preparing the return)

(Address of firm or employer)

INTERNAL REVENUE SEAL

66

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(Testimony of Todd W. Johnson.)

Mr. Johnson: No objections.

Mr. Mitchell: Mr. Johnson, as your attorney will you stipulate that the income tax return of Esther Jeanne Johnson for the year 1935 was made out in your office under your supervision by your secretary or bookkeeper?

Mr. Johnson: By me.

Mr. Mitchell: Made out by you?

Mr. Johnson: Yes.

Mr. Mitchell: And will you stipulate that it was identical with the return filed by you which is now in evidence as Defendant's Exhibit A?

Mr. Johnson: It was identical with the exception of [158] name, address, signature, and if it was necessary to change the gender in pronouns, that was changed.

Mr. Mitchell: Does your stipulation include the answer to Question No. 11, appearing at the top of the return, answer to questions?

Mr. Johnson: Yes.

Mr. Mitchell: Mr. Johnson, as your attorney, will you also stipulate to the following facts regarding the complaint of Esther Jeanne Johnson v. Todd W. Johnson, Superior Court, Los Angeles County, No. 129957:

That the suit was commenced by filing Mrs. Johnson's complaint on the 5th of March 1935. That has already been stipulated in the stipulation of facts that the grounds alleged in the complaint were cruelty;

(Testimony of Todd W. Johnson.)

That the interlocutory decree was entered on the 1st of April, 1935;

That the final decree was entered on April 2, 1936;

That paragraph 4 of the complaint reads as follows: "That on the 4th day of March 1935, plaintiff and defendant entered into an agreement in writing, settling and determining their respective property rights arising from said marriage, which agreement in writing obligates defendant, among other things, to pay to plaintiff for her support and maintenance the sum of $500 per month, payable at the rate of $250 on the 1st and $250 on the 15th of each month, commencing as of March 1, 1935, and continuing for a period of 12 months"; [159]

That paragraph 2 of the prayer of the complaint reads as follows: "That the property settlement agreement entered into between plaintiff and defendant be approved by this honorable court, and that the applicable parts thereof be incorporated in the decree of this honorable court";

That paragraph 3 reads, "A prayer for general relief";

That the complaint is signed by W. I. Gilbert and Hugh W. Darling, attorneys for the plaintiff;

That the default of the defendant was requested and entered in due course;

That the interlocutory decree was dated March 29, 1935, and was docketed and entered on April 1, 1935, in Book 903, page 249;

(Testimony of Todd W. Johnson.)

That the interlocutory decree recites the default of the defendant. It adjudges that the plaintiff is entitled to a divorce one year after the entry of the interlocutory decree, and that the decree contains the following paragraphs:

"It is further adjudged that the property settlement agreement between plaintiff and defendant dated the 4th day of March 1935, an executed copy of which was introduced into evidence and marked Plaintiff's Exhibit 1, be, and it is, hereby approved;

"It is further adjudged that the defendant be, and he is hereby, ordered to pay to plaintiff as alimony for her support and maintenance the sum of $500 per month for a period of one year, commencing as of the first day of March 1935, payable at the rate of $250 on the 1st of each month [160] and $250 on the 15th of each month."

That there was no award of costs or attorneys' fees in the decree, and no mention in the decree of a division of community property other than the reference to the agreement;

That the final decree was dated April 2, 1936, and was entered and docketed on the same day in book 935, page 349;

That the final decree recites the entry of the interlocutory decree, dissolves the bonds of matrimony, and adjudges a divorce; and it further contains the following paragraph:

"It is further ordered and decreed that wherein said interlocutory decree makes any provision for

(Testimony of Todd W. Johnson.)

alimony or the custody and support of children, said provision be, and the same is hereby, made binding on the parties affected thereby, the same as if herein set forth in full, and that wherein said interlocutory decree relates to the property of the parties hereto, said property be, and the same is hereby, assigned in accordance with the terms thereof to the parties therein declared to be entitled thereto";

That the summons and complaint in the case was personally served upon the defendant, Todd W. Johnson, on the 6th of March 1935, and that a certified copy of the interlocutory decree was personally served upon the defendant, Todd W. Johnson, on April 3, 1935.

Mr. Johnson: I will.

Mr. Mitchell: The defendant rests, your Honor.

[161]

Mr. Mitchell: If the Court please, may I just make this suggestion: If the Court should ultimately decide that the transaction is a sale and purchase transaction, which will necessitate going into the considerations paid and received by each of the parties, the Government may desire to introduce some expert testimony, and I think it would be difficult for the Court to decide the value of certain intangible rights and powers without the assistance of an expert, but that would entail considerable expense and considerable time.

(Testimony of Todd W. Johnson.)

The Court: I might consider it, but I don't believe there is any expert in the world that could give you or myself any light on those intangibles. It is just a wild guess. [164]

[Endorsed]: No. 10214. United States Circuit Court of Appeals for the Ninth Circuit. Todd W. Johnson, Appellant, vs. United States of America, Appellee. Transcript of Record. Upon Appeal from the District Court of the United States for the Southern District of California, Central Division.

Filed August 7, 1942.

PAUL P. O'BRIEN,
Clerk of the United States Circuit Court of Appeals for the Ninth Circuit.

In the United States Circuit Court of Appeals
For the Ninth Circuit
No. 10214

TODD W. JOHNSON,
Plaintiff and Appellant,
vs.
UNITED STATES OF AMERICA,
Defendant and Appellee.

STATEMENT OF POINTS ON WHICH APPELLANT INTENDS TO RELY UPON APPEAL

Appellant hereby adopts and relies upon the Statement of Points filed in the trial or District

Court and designates the following parts of the record on appeal as necessary for consideration of said appeal and to be printed:

[Here follows designation by appellant of portions of transcript to be printed.]

Dated: August 6th, 1942.

TODD W. JOHNSON
In Propria Persona, Appellant.

Received copy of the within Statement of Points on Which Appellant Intends to Rely Upon Appeal and Designation of Parts of Record to Be Printed this 6th day of August, 1942.

WM. FLEET PALMER,
United States Attorney.

E. H. MITCHELL
Assistant United States Attorney.

By E. H. MITCHELL
Assistant United States Attorney,
Attorneys for Defendant-Appellee.

[Endorsed]: Filed Aug. 7, 1942.

In the District Court of the United States in and for the Southern District of California
Central Division

No. 1195-O'C

TODD W. JOHNSON,

Plaintiff,

vs.

UNITED STATES OF AMERICA,

Defendant.

MOTION TO AMEND AND TO MAKE ADDITIONAL FINDINGS AND CONCLUSIONS UNDER RULES 52(b) and 59(a) (2)

The defendant above named moves (1st) that the Findings of Fact and Conclusions of Law, heretofore concurrently entered with the Judgment in above case on the 30th day of June 1942, be amended in the particulars hereinafter pointed out and (2d) that the Court make the new and additional findings and conclusions set forth below.

FINDINGS

Defendant moves that the following findings or portions thereof as indicated be stricken or amended for the reasons and upon the grounds stated.

I.

There is neither sufficient nor substantial evidence nor is there any law to support that portion of Finding V to the effect that the wife, as well as

the husband, "intended to and did * * * dispose of" the community property which was the subject of the agreement. [74]

A married woman, during marriage, cannot "dispose" of community property traceable to her husband's earnings.

II.

There is neither sufficient nor substantial evidence to support that portion of Finding VII to the effect that the $6,000.00 alimony payment alone, or any part thereof alone, was, "in full satisfaction of and constituted a complete discharge of" the husband's legal duty to support and maintain his wife.

The agreement must be read as a whole and it contains no such provision or expression of intent. A written contract cannot be so amended by a court in the absence of fraud or mutual mistake.

III.

There is neither sufficient nor substantial evidence, nor is there any law, to support that portion of Finding VIII to the effect that the wife "disposed" of her so-called "half interest" in the community property. (P. 3, lines 21-24)

It is elementary that California wives cannot "dispose" of their limited interests in community property during marriage.

Defendant moves that the following be substituted for such portion of Finding VIII, to-wit:

In so far as it related to community prop-

erty, real and personal, the wife "conveyed" nothing, but did release and relinquish her statutory marital rights in respect of the items transformed by the agreement into the husband's separate property. As between the parties themselves, no written instruments of conveyance or transfer, other than the agreement, [75] was necessary to legally transform such community property, real or personal, into the separate property of either spouse, regardless of the name or names in which held.

IV.

There is no evidence whatsoever to support the following portion of Finding IX, to-wit:

> the value of the undivided one-half interest of each spouse in said community properties, at the time of the agreement, was also exactly one-half the value of the whole property.

Such portion of Finding IX is also incomplete and misleading, unless there be added thereto the following, to-wit:

> The interest of the wife, however, in and to such community properties did not, at such time, include the right or power to use, possess, control, manage, contract respecting, pay debts with, sell, mortgage, pledge, or otherwise dispose of her so-called "one-half interest" therein. All such rights and powers were then vested exclusively in plaintiff to the extent of 100% thereof. His wife did then have

power, however, by contract with plaintiff but with no one else, to transform such community property into the separate property of herself or husband. She also had power to set aside any gifts thereof which might have been made by plaintiff without her consent. None of the ordinary incidents or attributes of ownership could accrue to her in respect of such community property except by agreement with plaintiff, by a gift from her husband, by divorce, or by plaintiff's prior death. The [76] fundamental purpose of the community property system is, and always has been, to safeguard and protect wives against want, upon the future possible dissolution of marriage by the death of husbands and by divorce. None of the burdens or obligations of ownership of community property traceable to the husband's earnings are imposed upon the wife. All are imposed personally and exclusively upon the husband to the extent of 100% thereof.

The finding to the effect that the value of the wife's interest in community property is equal to the value of the husband's interest is supported by no evidence whatever.

V.

The words "disposed of and", appearing in Finding X, p. 4, line 3, should be stricken, in so far as it relates to the disposal of community property by the wife. While she had power to "transform"

community property into the husband's separate property, by agreement with him, there is no evidence that the husband conferred upon her the power to "dispose" thereof.

VI.

Item 12 of Finding XI should be stricken. There is no evidence whatever as to the cost of cash in any bank.

VII.

The words "or the community", appearing in Finding XIII, p. 5, line 30, should be stricken. The community is not a separate entity capable of contracting or owing debts in California. [77]

VIII.

Finding XIV, in so far as it relates to the "cost" of each spouse's interest in the community property, should be stricken.

While there is evidence of the cost of certain tangible community properties, there is no evidence whatever in the record to indicate the cost to the husband of his interest therein or to indicate the cost to the wife of her interest therein.

Such portion of Finding XIV is also wholly immaterial in view of the first sentence of Finding VIII to the effect that the transaction evidenced by the agreement did not constitute reciprocal sales or exchanges. The insertion of a finding of costs can result in nothing but confusion to a reviewing court.

IX.

Findings XVI to XX, inclusive, should be stricken. They are also wholly immaterial in view of the first sentence of Finding VIII to the effect that the transaction evidenced by said agreement did not constitute reciprocal sales or exchanges.

In so far as they relate to the value and to the cost of the greatly different interests of the respective spouses in community properties, they are supported by no evidence whatever.

ADDITIONAL FINDINGS

X.

If the Court should deny defendant's motion to strike its findings relating to the value and the cost of the joint tenancy and community properties, and instead holds that such findings are material in spite of its [78] decision that the transaction evidenced by the agreement was in the nature of a division or partition (Conclusion VIII) and did not constitute reciprocal sales or exchanges, then there should be added the following finding in substance, towit:

> Plaintiff failed to establish the then value to him of his wife's release and relinquishment of her following marital rights, to-wit: (a) her right to support, maintenance or alimony for the remainder of her life; (b) her right to at least an equal division of community property in case of divorce; and (c) her right to administer upon his estate, to a probate homestead,

to a family allowance, and to inheritance in case he should predecease her during marriage. The wife's release of these marital rights and claims against plaintiff was of substantial monetary value to him and was one of the considerations for the agreement of March 4, 1935.

XI.

One of the contentions made in this case by the plaintiff is that the dissolution of the community relationship of the spouses was analogous to the dissolution of a partnership, and that the statutes and regulations relating to the realization by individual partners of taxable gains or deductible losses upon dispositions made subsequent to dissolution apply to the case at hand.

The Court decided this issue in favor of the Government, but made no finding or conclusion in response thereto. The following finding and/or conclusion, [79] therefore, should be added:

> The community property relationship existing between the spouses, at the time of the agreement, was not that of statutory or common law partners or joint adventurers, either in respect of the husband's uncollected earnings or in respect of the tangible community and joint tenancy properties. Plaintiff's collection of his earnings, which earnings were uncollected at the time of the agreement, was not a sale, exchange or disposition of property.

No such ground for recovery was set forth in his refund claim.

XII.

Another contention made by the taxpayer was that the agreement evidenced a transfer by the wife of half of certain accrued but uncollected receivables which, when collected by the transferee husband, were income taxable to the transferor wife, coming therefore within the principle invoked by the Supreme Court in the Horst and Eubank cases. The government contended to the contrary. Such issue was decided by the Court in favor of the Government, but it made no finding in response thereto. Hence, the findings are not complete unless the following be added.

> In respect of plaintiff's uncollected earnings and his contractual right to the law firm's net profits, his wife never possessed or enjoyed the legal rights, powers or interests of a statutory or common law co-partner, joint tenant or tenant in common. She never had command over the source of such earnings or net profits, and never possessed a single right, power or interest in respect thereof that she could assign to others. She could never have collected [80] the same or have commanded the payment thereof to anyone. The legal right to command, collect and receive payment of all thereof had accrued exclusively to plaintiff, was vested in him, and was not transferred to him by his wife as to all or any part thereof. Plaintiff's wife

realized no income whatever by virtue of the transformation of plaintiff's earnings and contractual right into his separate property, or by virtue of plaintiff's subsequent collection of such earnings and his share of such net profits, or by virtue of the two events or transactions combined.

Plaintiff's contention that the transformation of the accounts receivable into his separate property and his later collection thereof in the taxable year constituted the "realization" of income by his wife to the extent of one-half thereof, was not mentioned or set forth as a ground for recovery in his claim for refund.

XIII.

There is no evidence to support the following portions of the Court's Finding XXI:

1st. To the effect that the sums expended by the law firm for club dues and expenses, in the year 1935, were so expended for the then purpose of securing clients and building up firm business.

There is evidence that such was the purpose of similar expenditures made in the years 1931 and 1932, at the time of the inception of the law business. However, the evidence is undisputed that before 1935 the business had so grown that new clients and new legal business were no longer desired or needed. [81]

2nd. To the effect that "large legal fees were

received by the firm from contacts made in the year 1935 at these clubs." And

3rd. To the effect that the 1935 cost of club activities "was both ordinary and necessary to the operation in 1935 of the firm business."

CONCLUSIONS

The following conclusions of the trial Court are either misleading, inaccurate, unintelligible or immaterial, as pointed out below, and unless corrected or stricken will make for much confusion and will impose many unnecessary difficulties upon any court that may review the judgment upon the main issue herein.

I.

(a) The Court's Conclusion II is misleading because of omissions and because it is in apparent conflict with the last sentence of the Court's Finding III, p. 1, lines 28-32. Not only did the agreement "dissolve the community and joint tenancy character of the properties", but it also discharged the many marital obligations of the husband toward his wife and released him from all of the wife's legal claims against him. If the trial court is to make a conclusion as to the legal effects of the agreement, it should set forth all of such legal effects instead of merely part of them.

(b) Conclusion III is inaccurate unless amended by striking out the words "accounts receivable" (p. 8, line 21), and inserting in lieu thereof the words, "distributable profits." A firm's accounts receivable

are specific partnership property and hence are not community property. (Calif. Civ. Code, Sec. 2419 (2) (e)) [82]

(c) As it stands, Conclusion IV is also confusing and misleading in that a reviewing court would be justified in construing it to set forth the trial Court's sole reason for its decision on the main issue in this case. The Court's ultimate conclusion that all of the collections were taxable solely to the husband is based necessarily upon all the facts and all of the law. When a conclusion is based upon numerous factual and legal reasons, it is confusing, misleading and dangerous for a trial court to expressly base it upon but two facts. Particularly is this true where a party, as here, relies upon several alternative theories or contentions all of which have been decided against him. And particularly is it true where such losing party has, as here, announced his intention to appeal from such ultimate conclusion and in all probability will urge a review of the trial court's express or vaguely implied rulings upon each of such alternative contentions.

(d) Conclusion V is likewise inaccurate and misleading to the extent that it refers to "transfers" of community assets by each spouse to the other. It is to such extent inconsistent with that portion of the Court's Finding VIII (p. 3, lines 15 and 16) and with Conclusion VIII (p. 9, lines 24-27) to the effect that the transaction was in the nature of a "partition."

In so far as Conclusion V refers to a transfer by the wife of her so-called half interest in com-

munity assets, it is also inaccurate. She merely released or relinquished those protective rights or interests conferred upon her as the then potential widow or grass-widow of plaintiff. She never had power to "transfer" an undivided half of the community property to anyone.

(e) Conclusion VII, for the same reason and in [83] so far as it refers to a "transfer" by the wife, is likewise inaccurate and misleading.

(f) Conclusions IX, X, and XI, relating to cost, are wholly immaterial since the Court, in deciding the main issue against the plaintiff (Conclusions XII, XIII, XIV and XV), necessarily concluded that neither the transformation agreement nor the subsequent collection of receivables constituted sales, exchanges or disposals of property or capital assets within the meaning of Sections 22(e), 23(j), 111, 113 or 117 of the Revenue Act of 1934. In addition to this the Court concluded (Conclusion XV, p. 11, lines 1-5) that the collection by plaintiff of the receivables constituted the realization of income by him to the extent of 100% thereof, "without the deduction therefrom of any cost or other basis."

Such being the case, Conclusions IX, X and XI relating to the proper allocation of specified costs are wholly immaterial.

It may also be said that even were the exact cost of the interest of each spouse in each item of property essential to the judgment here rendered, there is no evidence whatever to indicate the respective

amounts thereof as set forth in said Conclusions IX, X and XI.

II.

For the purpose of accuracy and clarity, to avoid confusion and inconsistencies, and to simplify the task of any reviewing court, defendant moves that Conclusions II through XV be stricken and that there be substituted therefor Conclusions II through VIII heretofore "proposed" by the Government. [84]

This motion is made upon the grounds stated, and upon the further ground that Rule 8 of this Court, requiring that all findings shall be prepared by the successful party, was not complied with in this case in respect of the main issued which was decided in favor of the Government. The motion is also made upon all of the pleadings, briefs, points and authorities, exhibits, reporter's transcript of proceedings, the opinion and the findings and conclusions in this action.

Dated: July 9, 1942.

WM. FLEET PALMER
United States Attorney
E. H. MITCHELL,
Asst. United States Attorney
By E. H. MITCHELL
Attorneys for Defendant.

[Endorsed]: Filed Jul. 9, 1942. [85]

At a stated term, to wit: The February Term, A. D. 1942 of the District Court of the United States of America, within and for the Central Division of the Southern District of California, held at the Court Room thereof, in the City of Los Angeles on Friday the 31st day of July in the year of our Lord one thousand nine hundred and forty-two.

Present: The Honorable: J. F. T. O'Connor,
District Judge

[Title of Cause—No. 1195-O'C Civil.]

The motion of defendant to amend and to make additional Findings and Conclusions under Rules 52-b and 59-a, pursuant to notice filed July 16, 1942, having been argued and submitted forthwith, and the Court having duly considered the matter, now causes its Memorandum to be filed, and pursuant thereto denies the motion of defendant to amend and to make additional Findings and Conclusions.

[86]

[Title of District Court and Cause.]

MEMORANDUM

Philip D. Johnston and Otis T. Graham, Jr., Attorneys for Plaintiff, Los Angeles, California.

William Fleet Palmer, United States Attorney; E. H. Mitchell, Assistant United States Attorney; and Armond Monroe Jewell, Assistant United States Attorney, Attorneys for Defendant.

O'Connor, J. F. T., Judge.

The motion to amend and to make additional findings of fact and conclusions of law under Rule 52 (b) and 59 (a) (2) came on regularly to be heard before the court on the 27th day of July, 1942, and the court having heard arguments of counsel and having been fully advised in the premises, denies the motion to amend and to make additional findings and conclusions.

Dated July 31, 1942.

J. F. T. O'CONNOR,
Judge.

[Endorsed]: Filed Jul. 31, 1942. [87]

No. 10214.

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

TODD W. JOHNSON,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

BRIEF FOR THE APPELLANT.

TODD W. JOHNSON,
742 Title Insurance Building, Los Angeles.
In Propria Persona.

Independent-Review, Law Printers, Los Angeles, Calif.

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No. 10214.

IN THE

United States Circuit Court of Appeals

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TODD W. JOHNSON,

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vs.

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Appellee.

BRIEF FOR THE APPELLANT.

---

1. Jurisdiction.

This appeal involves income tax and is taken from a judgment of the District Court of the United States for the Southern District of California, Central Division, entered June 30, 1942. [R. 66, 67.] The opinion, special findings of fact and conclusions of law may be found in the record [pp. 43-65]. Notice of appeal was filed July 13, 1942. [R. 67-68.] The jurisdiction of this Court is invoked by virtue of the provisions of Section 128(a) of the Judicial Code, as amended by the Act of February 13, 1925.

2. Questions Presented.

1. Does appellant's wife, who owned half of certain accounts receivable, consisting of legal fees earned but not collected and on which no income tax has been paid, escape payment of the income tax thereon, by transferring her half of said fees to appellant in a property settlement and receiving in lieu thereof a one-half interest in other property, which interest has a market value equal to the face value of said half of said accounts receivable?

2. Is appellant taxable on the entire amount collected by him from the half of said legal fees acquired from his wife in a property settlement by transferring his half of other property to her, or is he entitled to recover the cost of his half of the property transferred to his wife before realizing any taxable income?

3. Statutes Involved.

Revenue Act of 1934:

"Sec. 22. GROSS INCOME.

(a) General Definition.—*Gross income includes gains, profits and income derived from* salaries, wages or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, business, commerce, or *sales or dealings in property,* whether real or personal, *growing out of the ownership or use of or interest in such property;* also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, *or gains or profits and income derived from any source whatever.* * * *

* * * * * * * * *

(e) Determination of Gain or Loss.—In the case of a sale or *other disposition of property,* the gain or loss shall be computed as provided in section 111.

* * * * * * * * *

Sec. 111. Determination of Amount, and Recognition of, Gain or Loss.

(a) Computation of Gain or Loss.—The gain from the sale or *other disposition of property* shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) Amount Realized.—The amount realized from the sale or *other disposition of property* shall be the sum of any moneys received plus the fair market value of the property (other than money) received.

Sec. 112. Recognition of Gain or Loss.

(a) General Rule.—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) Exchanges Solely in Kind.—

(1) Property Held for Productive Use or Investment.—No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

* * * * * * * * *

(c) GAIN FROM EXCHANGES NOT SOLELY IN KIND.—

(1) If an exchange would be within the provisions of subsection (b) (1), (2), (3), or (5) of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

* * * * * * * * *

Sec. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) Basis (Unadjusted) of Property.—The basis of property shall be the cost of such property; except that— * * *

(6) Tax-Free Exchanges Generally.—If the property was acquired, after February 28, 1913, upon an exchange described in section 112 (b) to (e), inclusive, the basis shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was made. If the property so acquired consisted in part of the type of property permitted by section 112(b) to be received, without the recognition of gain or loss, and in part of other property, the basis provided in this paragraph shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent

to its fair market value at the date of the exchange. This paragraph shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it.

* * * * * * * * *"

(Italics supplied by appellant.)

4. Statement of Facts.

At all times involved herein appellant and his wife were residents of California. [R. 51, 77, 78.] They were married in 1921. [R. 51.] From 1925 to January 1, 1935, when they separated permanently, they lived together as husband and wife. [R. 51.] On March 4, 1935, they made a written property settlement [R. 12 to 19, inclusive], dividing equally between them all of their joint and community property. [R. 52.] Each spouse received all of certain properties instead of an undivided half of each item of property. [R. 52.] All of the properties owned by them on March 4, 1935, consisting of both community and joint tenancy property, were acquired after July 29, 1927, and were traceable to legal services performed by appellant as a member of the marital community. [R. 51, 52.] On April 1, 1935, Mrs. Johnson obtained an interlocutory, and on April 2, 1936, a final divorce decree. [R. 52, 53.] Appellant discharged his liability, if any, for the support of or alimony to his wife, by agreeing to pay and later paying her $500.00 per month for one year. [R. 53.]

The fair market value of all the community and joint property on March 4, 1935, was $172,379.41. [R. 55.] This total of $172,379.41 included accounts receivable of the face and market value of $52,028.45, representing legal fees earned but not collected. [R. 55.]

The total cost of all of said community and joint property was $135,430.35. [R. 56.] Said fee accounts receivable had no cost to the two spouses. [R. 56.] Total depreciation had been sustained and allowed in the income tax returns of the two spouses in the sum of $3,590.84. [R. 56.] Each spouse owed income tax of $5,082.78 for the year 1934 and $3,118.95 for the year 1935 on the basis of their returns as filed. [R. 56, 57.]

The cost to each spouse of his or her one-half interest on March 4, 1935, in each particular property owned by the two spouses jointly was exactly one-half of the total cost to the community or to the two spouses of said particular property. [R. 57.]

In the property settlement transaction appellant acquired his wife's half of property having a total market value of $49,189.71, computed as follows: $26,014.23 for her half of $52,028.45 of fee accounts receivable and $23,175.48 for her half of other community and joint property. [R. 58.]

In said transaction appellant transferred or gave up to his wife his half of joint and community property which had a cost to him of $38,610.41, on which amount he had already paid an income tax, and he also assumed and paid her 1934 and 1935 income taxes totaling $8,201.73, making a total of $46,812.14 given up to or paid for her by him. [R. 59.]

Appellant's wife thereby acquired appellant's half, having a market value of $37,000.00, of certain joint and community property and also had her 1934 and 1935 income taxes in the amount of $8,201.73 assumed and paid by appellant, making a total of $45,201.73 acquired by her in the property settlement. [R. 59.]

She transferred or gave up to appellant her half of certain accounts receivable on which she had no cost, and also her half of certain other joint and community property which had cost her $27,309.53. [R. 59.] She had already paid an income tax on this $27,309.53. [R. 59, 60.]

Appellant included as income one-half of the collections of said fee accounts receivable of $52,028.45 or $26,014.22, in his 1935 income tax return and his wife included the other half thereof in her return as her income. [R. 80, 81, 82, 83.] Both spouses filed all of their income tax returns, including the ones for 1935, upon the cash basis. [R. 79.] The Commissioner of Internal Revenue determined that appellant was taxable on the entire $52,028.45 collected by him from said accounts and that his wife was taxable on no part thereof. [R. 80, 81, 82, 83.] The lower court affirmed the Commissioner's determination. [R. 46, 47.]

5. Specification of Errors to Be Urged.

1. The District Court erred in holding that appellant received taxable income of $52,028.45, instead of $26,014.23, when he collected certain accounts receivable representing legal fees earned but not collected, because he owned all instead of half of said accounts at the time they were collected, notwithstanding the fact that he only owned a community half therein when said fees were earned and despite the fact that he acquired his wife's community half thereof in a property settlement whereby he gave up or conveyed to her his half of other joint and community property having a cost and value equal to the face and market value of said accounts.

2. The District Court erred in failing to hold as a matter of law that because appellant's wife owned half of said fees at the time they were earned, she was taxable on half thereof when said fees were collected by appellant.

3. The District Court erred in failing to hold that the transfer to appellant by his wife of her community half of said accounts receivable, representing legal fees already earned but not collected, in return for appellant's half of other community and joint property and his payment of her 1934 and 1935 income taxes, was a taxable event or final event of enjoyment whereby she realized income or gain on a cash basis to the full extent of her half of said fees.

4. The District Court erred in failing to hold that appellant's wife realized gain or loss in the property settlement, computed or based upon the difference between the cost of her half of certain joint and community property, which she transferred to appellant, and the market value of appellant's half of certain other joint and community property which he transferred to her.

5. The District Court erred in failing to hold that appellant realized gain or loss in the property settlement only upon the difference between the cost of his half of certain joint and community property which he transferred to his wife (plus certain of her income taxes assumed and paid by him) and the market value of her half of said accounts receivable and other joint and community property which she transferred to him.

6. The District Court erred in failing to hold that said property settlement was a sale, exchange or disposition of, or dealing in, property whereby gain or loss was realized by each spouse, based upon the difference between his or

her cost of the one-half interest conveyed to, and the market value of the one-half interest received from, the other spouse, with proper adjustment for income tax of his wife assumed and paid by appellant.

7. In the alternative, even if the property settlement was a tax free exchange, disposition of or dealing in fractional interests in property, on which no gain or loss was recognized to either spouse, the District Court erred in failing to hold that before appellant realized any taxable income when he subsequently disposed of the half of said fees acquired from his wife by collecting the sum of $26,014.23, he was entitled to recover the sum total of his cost of his half of certain other joint and community property which he gave up or transferred to her and her 1934 and 1935 income taxes paid by him for her.

8. The District Court erred in failing to hold that, regardless of whether the property settlement was a transaction whereby gain or loss was or was not recognized to each or either of the spouses, appellant was entitled to recover his cost of his half of the joint and community property which he transferred to his wife, and the income taxes paid by him for her, before he realized any taxable income from his subsequent disposition by collection of the half of said accounts acquired from her.

6. Summary of Argument.

In the property settlement transaction appellant transferred or surrendered to his wife his half of property with a cost of $38,610.41, on which he had already paid income tax, and assumed and paid her income tax of $8,201.73, or a total of $46,812.14. He acquired from his wife her half of other property, with a market value of $49,189.71,

which total includes her half of said fee accounts receivable at face value of $26,014.23.

At no time could he possibly have income of more than $2,377.57, being the difference between $49,189.71 and $46,812.14, regardless of whether the property settlement was a transaction whereby gain or loss is recognized to the two spouses.

If gain is recognized at the time of the property settlement appellant had taxable income of $2,377.57 but he had no further gain when he collected his wife's half of the accounts receivable, because their full fair market value is taken into account in computing the gain of $2,377.57.

If no gain or loss is "recognized" at the time of the property settlement the gain "realized" is still the same as if "recognized," but the reporting of such gain for income tax purposes is deferred until the property acquired by each spouse from the other is disposed of. Thus in 1935 when appellant disposed of part of the property he acquired from his wife, viz., her half of the fee accounts receivable, $1,257.39 of the realized gain of $2,377.57 would be "recognized" computed as follows: $\frac{\$26,014.23}{\$49,189.71} \times \$2,377.57 = \$1,257.39$. The balance of the "realized gain" would not be "recognized" until he disposes of the other property acquired from his wife.

Appellant's wife transferred or surrendered to appellant her half of property with a cost of $27,309.53, on which she had already paid income tax and her half of the fee accounts receivable on which she had no cost and had paid no income tax. She acquired from appellant his half of property having a market value of $37,000.00 and had her income taxes of $8,201.73 paid, thereby receiving a

total of $45,201.73. She therefore actually "realized" a gain of $17,892.20, being the difference between $45,-201.73 and $27,309.53, regardless of whether such gain is then "recognized" for income tax purposes, or deferred until she disposes of the property acquired from appellant.

If gain is "recognized" when the property settlement was made she had taxable income of $17,892.20 in 1935. If the gain is not then "recognized," she nevertheless "realized" the same gain of $17,892.20, but such gain is not "recognized" for income tax purposes until she disposes of the property acquired from appellant.

When a taxpayer once owns accrued or earned income he or she must pay the income tax thereon and cannot by transferring it to someone else escape paying the income tax thereon. On the accrual basis of accounting the owner of income is taxable the minute the income accrues or is earned, regardless of whether said owner afterwards transfers it to someone else or not. On the cash basis the owner does not pay income tax on the income until it is collected or until he or she transfers it for a valuable consideration, but once he or she owns the income he or she must pay income tax on it when it is realized by a "taxable event" which is generally the collection thereof. When the owner of accrued or earned income disposes of it by gift he or she is taxable thereon when the transferee collects it, but when he or she disposes of such income for a valuable consideration in money or money's worth a "taxable event" occurs and he or she is taxable immediately on the consideration received.

Appellant's wife received exactly the same economic benefit by transferring or surrendering her half of said fee accounts receivable to appellant as if she had collected her half and then purchased with the proceeds thereof

appellant's half of the property which she acquired from him. Having received such economic benefit she is taxable on her half of said fees.

Ownership at the time income accrues or is earned determines the person who is taxable thereon and the ownership at the time the income is collected is immaterial —*Horst* and *Eubank* cases, *infra*. The lower court held that ownership at the time of collection determines the person taxable on such income and therefore such decision should be reversed.

7. Argument.

At the outset appellant wishes to emphasize that only the taxability of his wife's one-half of the accounts receivable, representing fees earned but not collected, is involved herein. In his 1935 income tax return appellant reported and paid a tax on income of $26,014.23, representing his half of said accounts receivable of $52,028.45. [R. 80, 81, 82, 83.] It is only the $26,014.23 collected by him from the one-half interest in said accounts acquired from his wife in the property settlement which is involved in this case. [R. 53.]

Appellant's payment of monthly alimony for one year to his wife does not affect this case and will not be commented upon unless mentioned in appellee's brief, in which event the matter will be discussed in appellant's reply brief.

Also appellant wishes to emphasize that this case involves income earn *before* but collected by appellant *after*

the property settlement agreement—or, in other words, *past earnings.*

The courts, with little if any conflict, have held that the transfer or assignment of *future earnings or income* does not relieve the assignor from income tax thereon. However, until the United States Supreme Court decided the *Horst* and *Eubank* cases, *infra,* there was a violent disagreement in the lower courts as to whether the transfer or assignment of income already accrued or earned relieved the assignor from income tax thereon. For instance in the *Eubank* case, *infra,* the United States Circuit Court of Appeals held the assignee taxable on assigned income already earned or accrued, while in the *Van Meter* case, *infra,* a different United States Circuit Court held the assignor taxable thereon. The correct law on this point was settled in the *Eubank* and *Horst* cases, *infra,* when the United States Supreme Court held that the assignor and not the assignee was taxable on income which was already earned or accrued when assigned.

In the present case the community was the earner and owner of the legal fees in question, which had been earned and had accrued prior to the property settlement. Each spouse, like a partner, owned one-half of said earnings as a member of the marital community. (*Poe v. Seaborn,* 282 U. S. 101, 51 S. Ct. 58; *U. S. v. Goodyear* (C. C. A. 9), 99 Fed. (2d) 522.) While appellant's wife could and did transfer her one-half interest in said legal fees to appellant, such transfer could in no way affect her liability for income tax thereon which attached to said earnings the moment they were earned. (*Van Meter* and *Eubank* cases, *infra.)*

I.

The Right of Spouses in California to Agree That the Future Earnings of a Particular Spouse Shall Be His or Her Separate Property Is Only a Right of Emancipation.

Such cases as *Helvering v. Hickman,* 70 Fed. (2d) 985; *Harold G. Ferguson,* 34 B. T. A. 532; *George J. Somerville v. Commissioner,* 43 B. T. A. 968, and *Dale Van Every* (C. C. A. 9, Jan. 5, 1940), 108 Fed. (2d) 650 (certiorari denied April 22, 1940, 60 S. Ct. 891), are not in point because they involve earnings of a husband both earned and collected after the date of a property settlement, or in other words "future earnings." Furthermore, they do not involve the transfer or assignment of such "future earnings" but only the principle of *emancipation.*

These cases only stand for the proposition that by agreement either spouse in California may so *emancipate* the other spouse that his or her *future earnings* become not only the separate property of, but taxable to, the particular spouse emancipated. The particular spouse earning the income would then be taxable on his or her entire future earnings because such spouse would own the right to such earnings at the very time they were earned. This is exactly the same principle involved in the emancipation of a married woman by her husband in a separate property state or of a minor child by a parent and goes no further in its effect.

Kaltschmidt v. Weber, 79 Pac. 272, is sometimes cited as authority for the principle that the parties to a marital community may agree that *past* as well as *future* earnings shall be separate property and that the effect of such an agreement will be to convert such earnings from the status

of community property to that of separate property of the wife. It would appear from an examination of the *Kaltshmidt* case that only "future earnings" and not "past earnings" were there involved, but in any event the fact that a spouse may assign his or her half of certain income to the other spouse does not establish the principle that the assignor is thus relieved from income tax thereon.

The *Kaltshmidt* case, *supra,* was decided on the authority of *Wren v. Wren,* 100 Cal. 276, 34 Pac. 775. The *Wren* case, *supra,* was in turn decided upon the authority of *Riley v. Mitchell,* 36 Minn. 3, 29 N. W. Rep. 586. The *Riley* case involved a situation where a husband in Minnesota, a separate property state, emancipated his wife and agreed with her that her earnings should be her own property and not the property of the husband. At common law the wife's earnings belong to the husband and the Court held that by agreement he could make them hers—or emancipate her.

Obviously then this right of emancipation in California is only a right to release a spouse of his obligation to earn money for the marital community. This emancipation could only effect future earnings from the date thereof *for income tax purposes.* A child's earnings prior to emancipation would belong to the parent. A wife's earnings at common law prior to emancipation would belong to the husband. Likewise in a community property state the earnings of both spouses prior to emancipation belong to the marital community. *(Poe v. Seaborn, Goodyear* case, *supra.)*

Such emancipation would not apply to past earnings because such earnings would already be property and belong to the marital community. As property past earnings

can be transferred by agreement in the form of a gift, sale or other transaction, but such a transfer could not affect the liability of the transferor spouse to pay income tax on his or her community one-half thereof.

Unless this is the correct construction a husband and wife in California can agree that both the past and future earnings of the husband shall be the separate property of the wife and thus make all the past and future earnings of the husband taxable to the wife. Let us take the case of a husband who has a large separate estate and has a large income other than his salary, whereas his wife has no income other than her half interest in his salary. By agreement the husband then could make his past and future salary earnings her separate property and she would be taxable on the entire amount thereof. Obviously this is not the correct law, and while the husband has the right to transfer his community half of his past or future earnings to her, he cannot thus escape tax thereon.

This is so as to future earnings because in agreeing that his community half of his salary is the separate property of the wife, neither the husband nor the wife are emancipated. An emancipation requires the person emancipated to be the one who earns the income. As to his community half of his past earnings his income tax liability would attach the minute the income was earned and no subsequent act of his could relieve him from such tax. While such an agreement by the husband to make his salary the separate property of the wife would be effective as between the spouses, and such past or future earnings would be the separate property of the wife when earned by the husband, nevertheless he would still be taxable on

his community one-half of both his past and future earnings.

Likewise a husband in a separate property state can make at least his past earnings, and probably his future earnings, the separate property of his wife. *(Horst, Eubank, Schaffner* and *Van Meter* cases, *infra.)* For instance, let us take the case where a husband in either a separate or community property state assigns half of his future earnings to his wife in a property settlement agreement as alimony or in lieu of alimony. There would thus be a valid consideration for the assignment and such earnings would certainly be the separate property of the wife, but the husband could not successfully contend that, because one-half of his earnings was the separate property of the wife when collected, he is only taxable on half of his earnings.

In the case of *F. Eldred Boland,* 41 B. T. A. 930, a California husband attempted to assign 25% of his future earnings to his wife in a property settlement, but the Board of Tax Appeals rightly held that he was still taxable on the portion assigned to his wife. The Board held the marital community was terminated by the agreement. Therefore, the husband was in the same position as a husband in a separate property state. While the assignment of his earnings was perfectly good between the parties the Board held it did not relieve him from tax on the portion of his earnings assigned to the wife. The *Boland* case is therefore authority for the proposition that although a husband and wife can agree between themselves as to whose separate property the earnings of either may be, nevertheless this in no way determines who is to pay the tax on such assigned earnings. The taxability is de-

termined without reference to the assignment. In the *Boland* case there was unquestionably a consideration for the assignment which, under the rule applied by the lower court in this case, would make the wife taxable on the earnings assigned to her; there was as much a "division" of property in the *Boland* case as in the present case; there certainly was no gift or sale involved in that case; and the agreement unquestionably was valid as between the spouses.

The Board in the *Crosby* case, *infra,* cites the *Boland* case as authority for the proposition that a wife can assign to a husband her half interest in his past earnings and thus escape tax thereon. That point was not raised or considered in the *Boland* case. The property settlement agreement in the *Boland* case was made in 1929 and the earliest year involved was 1934. Furthermore, while Boland was a lawyer, he was only an employee and not a member of the law partnership concerned, so that it would seem incredible that the firm in 1934 still owed him salary earned in 1929 or prior thereto.

Actually in the *Boland* case the husband received the same benefit as if he had collected 100% of his income and turned 25% over to his wife as alimony. Thus he received the full economic benefit of 100% of his income. He constructively received his wife's 25% and paid it on his alimony obligation.

In the present case appellant's wife received the same benefit as if she had collected her half interest in said fee accounts receivable because she received from appellant his half of other property of equal value. Therefore, she too constructively received her one-half of said earned income and is taxable thereon.

II.

The Property Settlement Should Be Viewed Exactly the Same as if It Were an Agreement Between Two Unmarried People Who Owned Common Property.

The right which a husband and wife have in California to contract with each other is no strange or extraordinary right. Under the old common law the rights of a husband and wife to contract with each other with reference to their property were greatly restricted. Sections 158 and 159 of the California Civil Code merely remove these restrictions. The pertinent portion of Section 158 of the California Civil Code is as follows:

> "Either husband or wife may enter into any engagement or transaction with the other * * * respecting property *which either* might if unmarried." (Italics supplied.)

The property settlement transaction should be considered simply as an agreement whereby two individuals, who own common property, each transfer to the other his or her one-half interest in certain property in consideration for a reciprocal transfer of an undivided interest in certain other property. If this is kept in mind the transaction should and will not be confused by the husband and wife relationship, inasmuch as each spouse is only making the same contract "which either might if unmarried."

III.

Taxation Is a Practical Matter and a Taxpayer Is Taxable to the Extent, and Only to the Extent, That He or She Has Actually Been Enriched by a Particular Transaction.

As stated by the Court in *First Seattle D. H. National Bank v. Commissioner,* 77 Fed. (2d) 45:

> "Moreover, in view of the principle that, *in applying income tax laws, the substance, and not the form, of the transaction should control,* the exchange and sale of stock which was required under the whole contract herein should be treated as a single, composite transaction for income tax purposes, regardless of the formalities followed. See S. A. MacQueen Co. v. Com'r, 67 F. (2d) 857, 858 (C. C. A. 3); Tulsa Tribune Co. v. Com'r, 58 F. (2d) 937, 940 (C. C. A. 10); Western Maryland Ry. Co. v. Com'r, 33 F. (2d) 695 (C. C. A. 4); United States v. Phellis, 257 U. S. 156, 158, 42 S. Ct. 63, 66 L. Ed. 180; Weiss v. Stearn, 265 U. S. 242, 254, 44 S. Ct. 490, 68 L. Ed. 1001, 33 A. L. R. 520. In dealing with a situation not unlike the one at bar, the court, in the case of West Texas Refining Co. v. Com'r, 68 F. (2d) 77, 80 (C. C. A. 10), quoting from Prairie Oil & Gas Co. v. Motter, 66 F. (2d) 309, 311 (C. C. A. 10), said: *'If a taxpayer sought to avoid a tax on the profits of such a sale as this by asking the Commissioner to ignore the actualities, he would shortly and properly be reminded that taxation is an intensely practical matter and that the substance of the thing done, and not the form it took, must govern.'*" (Italics supplied.)

In the present case the substance of the transaction is that appellant's wife transferred her half interest in the

fee accounts receivable and other assets to appellant and he in return transferred to her his half interest in other property and assumed and paid her 1934 and 1935 income taxes. To say that she realized no "gain" on this transaction is to ignore the actualities of the transaction. Likewise to say that appellant realized a "gain" or profit equal to the full amount collected by him from her half of said accounts ignores the fact that he transferred property to her, which added to her taxes assumed and paid by him equalled the face value of her half of said accounts. In effect appellant purchased his wife's one-half interest in said fee accounts receivable. By collecting such income he disposed thereof and his gain will be the excess, if any, of the amount received over his purchase price thereof.

IV.

Appellant Could not Have Received Income of More Than $2,377.57 by Acquiring and Collecting the $26,014.23 of Fee Accounts Receivable.

In the property settlement appellant transferred or gave up to his wife his one-half interest, costing $38,610.41, in certain joint and community property. [R. 59.] He had already paid an income tax on this $38,610.41. [R. 59.] He also assumed and paid his wife's 1934 income tax of $5,082.78 and her 1935 income tax of $3,118.95, or a total transferred to or paid for his wife in the sum of $46,812.14. [R. 59.]

In consideration for these acts by appellant, he received his wife's one-half interest, having a market value of $23,175.48, in certain other joint and community property, and her one-half interest, amounting to $26,014.23, in

said fee accounts receivable, or a total of $49,189.71. [R. 58.]

The Government contends that appellant is taxable on the sum of $26,014.23, which is the amount of his wife's one-half interest in the accounts receivable which were collected after the property settlement. However, since income tax is payable only on net income, appellant could not possibly be taxable on this amount, since his net income would be the difference between the amount he transferred to his wife, on which he had already paid an income tax ($38,610.41), and the net amount received in the property settlement ($40,987.98), or $2,377.57, arrived at as follows:

Market value of one-half interest in accounts receivable received from wife	$26,014.23
Market value of one-half interest in other property received from wife	23,175.48
	$49,189.71
Less 1934 and 1935 income taxes paid for wife	8,201.73
Amount received by appellant	$40,987.98
Less his cost of property transferred to wife on which he has already paid income tax	38,610.41
Actual net income "realized" by appellant	$ 2,377.57

The Government claims appellant realized income of $26,014.23 when he collected the one-half of the accounts receivable acquired from his wife. This cannot be correct because he has already paid income tax on $38,610.41 (the

cash used to buy his one-half interest in the property transferred to his wife) and if he is taxed on $26,014.23 more he will have paid an income tax on income of $64,624.64 and he only received $40,987.98. Since he has made no gift to his wife such a result is unreal and ignores the actualities of the transaction.

V.

Appellant's Wife Actually "Realized" Net Income of $17,289.20 in the Property Settlement.

Appellant's wife received appellant's half interest, having a market value of $37,000.00, in certain property and had debts paid for her in the sum of $8,201.73, a total of $45,201.73 received from appellant in the property settlement. [R. 59.] She gave up her half of the fee accounts receivable on which she had no cost, and gave up to him her half of other property on which she had a cost of $27,309.53 and on which she had already paid an income tax. [R. 59, 60.] Accordingly she received or "realized" net income of $17,892.20 computed as follows:

Market value of one-half interest in property received from appellant	$37,000.00
1934 and 1935 income taxes paid by appellant	8,201.73
Total market value of settlement received by wife	$45,201.73
Less cost of property transferred to appellant (on which tax has already been paid	27,309.52
Net income received by wife on which she had paid no income tax	$17,892.20

The Government claims appellant's wife realized no income by the property settlement. This cannot be right because she has only paid an income tax on $27,892.20 (the cost of her half interest in the property transferred to her husband) and she received $45,201.73. She was actually enriched by the difference of $17,892.20 and therefore "realized" net income of $17,892.20. Since appellant did not make a gift to her it would ignore the actualities of the transaction to say she realized no income.

If she has no taxable income by reason of the property settlement agreement, when, if at all, does she pay an income tax on this $17,892.20? If she is taxable on this $17,892.20 when she sells the one-half interest in the properties acquired from appellant and appellant is taxable on the $26,014.23, then the Government will receive a tax on income of $43,906.43 whereas the total income involved could only be $26,014.23. If she never pays an income tax on this $17,892.20 then she had paid a tax on only $27,309.53 and yet has received $45,201.73. In some unreal and technical manner she has acquired $17,892.20 on which she will never pay an income tax and yet no gift was involved.

Had this excess of $17,892.20 been received by her as alimony or for the release of any other marital right the contention might logically be made that she is not taxable thereon, but it is indisputable that she received the same as her share of the joint and community property. Actually she received slightly less than appellant although every effort was made to make an exactly equal division.

This court must decide whether, because of certain claimed legal technicalities or distinctions, which are more illusory than real, appellant must pay an income tax on a fictitious income of $26,014.23 and his wife is not taxable on any income or profit, or whether the actual result of the transaction is to be followed and that appellant is taxable on income in the amount of $2377.57 and his wife is taxable on income in the amount of $17,892.20.

VI.

Appellant's Wife Is Taxable on Her One-half of the Income Earned but Not Collected Prior to the Property Settlement Unless She Thereby Sold Her Half Interest to Appellant, in Which Event She Is Taxable on the Consideration Received.

Appellant's wife owned one-half of the earned but uncollected income under consideration, prior to the property settlement. (*Poe v. Seaborn, supra; U. S. v. Goodyear, supra; King v. Commissioner*, 26 B. T. A. 1158, affirmed 5th Circuit, 69 Fed. (2d) 639, 13 A. F. T. R. 747; *Albert Houston v. Commissioner of Internal Revenue*, 31 B. T. A. 188; *Delvin v. Commissioner*, 9th Circuit, 82 Fed. (2d) 731, 17 A. F. T. R. 690; *Asher v. Welch* (D. C. Cal.), 28 Fed. Sup. 893, 23 A. F. T. R. 664, affirmed 111 Fed. (2d) 59.) As the Court said in *Poe v. Seaborn, supra:*

> "The earnings (of the husband) are never the property of the husband, but that of the community." (Parenthetical clause supplied.)

There can be no doubt that she would have been taxable on her half of said earned but uncollected income

when it was collected had there been no separation agreement. (*U. S. v. Malcolm,* 282 U. S. 792, 51 S. Ct. 184, 9 A. F. T. R. 956; *Poe v. Seaborn, supra.*) On the accrual basis of accounting she would have been taxable the minute the fees in question were earned or accrued. Therefore, if appellant is to be held taxable on her half of such earned but uncollected income the wife must, in some manner, have escaped income tax thereon because the same income cannot be taxable to both.

It will now be shown that appellant's wife cannot escape paying income tax either on her half of said earned but uncollected income, or on the consideration which she received in lieu thereof, and therefore appellant is not taxable on her said half.

(a) Once a Person Becomes the Owner of Earned or Accrued Income There Is No Possible Way in Which He Can Avoid Ultimately Paying Income Tax Thereon.

If a cash basis taxpayer gives such income away he is still taxable on it when collected and the donee is not. (*Helvering v. Horst,* 311 U. S. 112, 61 S. Ct. 144; *Helvering v. Eubank,* 311 U. S. 122, 61 S. Ct. 149; *Harrison v. Schaffner,* 312 U. S. 579, 61 S. Ct. 759.

The *Horst, Eubank* and *Schaffner* cases, while involving gifts of income, when carefully analyzed, clearly stand for the broad general principle that *no owner of accrued but uncollected income can transfer the same by any conceivable device and relieve himself or herself from paying the income tax thereon.*

The Supreme Court in the *Schaffner* case, *supra,* referring to its previous decisions in the *Horst* and *Eubank* cases, set forth this principle in the following language:

> "Since granting certiorari we have held following the reasoning of Lucas v. Earl, *supra,* that one who is entitled to receive at a future date, interest or *compensation for services* and who makes a gift of it by an anticipatory assignment, *realizes taxable income quite as much as if he had collected the income and paid it over to the object of his bounty.* Helvering v. Horst, 311 U. S. 112, 61 S. Ct. 144, 85 L. Ed. ....., 131 A. L. R. 655; Helvering v. Eubank, 311 U. S. 122, 61 S. Ct. 149, L. Ed. ..... Decision in these cases was rested on the principle that the power to dispose of income is the equivalent of ownership of it and that the exercise of the power to procure its payment to another, *whether to pay a debt or to make a gift,* is within the reach of the statute taxing income 'from any sources whatever.'" (Italics supplied.)

Fairly construed this means that whenever an owner of earned or accrued income exercises "the power to procure its payment to another" whether for or without consideration, the income is taxable to the owner of the income who disposes of it. It is difficult to see how there could be a clearer expression of this general principle. It is even more difficult to see how when appellant's wife has exercised her power to procure the payment of her half of certain earned income to appellant and

has received in lieu thereof his half of certain other property, she can be said to have realized no income from the transaction.

If a cash basis taxpayer dies he must pay an income tax on all earned or accrued but uncollected income in his last income tax return. (Sec. 42, Rev. Act of 1934; *Helvering v. Enright,* 312 U. S. 636, 61 S. Ct. 777; *Pfaff v. Commissioner,* 312 U. S. 646, 61 S. Ct. 783.) Under the principle of these two Supreme Court cases clearly appellant's wife would have been taxable on her half of said fees had the community been terminated by death instead of by the property settlement agreement.

If a cash basis taxpayer receives cash from a third person in lieu of such accrued or earned income he is taxed on "the commuted payment" which "replaced the future income with cash." (*Helvering v. Smith,* 90 Fed. (2d) 590.)

Here appellant's wife "replaced the future income with" other property instead of "cash" and she should be taxed on the market value of such property. In fact unless this is the correct rule a cash basis taxpayer can easily avoid income tax by simply trading income earned or accrued but not collected for other property. Of course the correct rule is that such a taxpayer is taxable on the market value of the property which replaces the future income and there is no loophole.

(b) When a Cash Basis Taxpayer Does Not Actually Collect Accrued Income but Makes Some Other Disposition Thereof a "Taxable Event" Occurs Which Makes Him Taxable Immediately on the Uncollected Income.

In the case of a taxpayer reporting on the cash receipt and disbursement basis commonly known as the "cash basis" two things must happen before he receives taxable income, viz.: First, the income must have been earned or accrued in the case of ordinary income and the capital increment must have occurred in the case of capital gain, and, second, there must be a "taxable event" whereby the earned or accrued income or the capital increment is realized by the owner thereof.

On the accrual basis only the first thing must occur, viz., the income must have been earned, or accrued whereupon the owner of the income is immediately taxable thereon. In this case, had appellant and his wife been reporting their income on the "accrual" instead of the "cash" basis, each would have been taxable on one-half of said fees prior to the property settlement because the fees were earned or accrued prior thereto.

This "taxable event" is called the "final event of enjoyment" in the *Horst* case, *supra*, where the Court said as follows:

> "In the ordinary case the taxpayer who acquires the right to receive income is taxed when he receives it, regardless of the time when his right to receive payment accrued. *But the rule that income is not*

taxable until realized has never been taken to mean that the taxpayer, even on the cash receipts basis, who has fully enjoyed the benefit of the economic gain represented by his right to receive income, can escape taxation because he has not himself received payment of it from his obligor. The rule, founded on administrative convenience, is only one of postponement of the tax to the *final event of enjoyment* of the income, usually the receipt of it by the taxpayer, and not one of exemption from taxation where the enjoyment is consummated by some event other than the taxpayer's personal receipt of *money or property.* Cf. Aluminum Castings Co. v. Routzahn, 282 U. S. 92, 98. *This may occur when he has made such use or disposition of his power to receive or control the income as to procure in its place other satisfactions which are of economic worth.* The question here is, whether because one who in fact receives payment for services or interest payments is taxable only on his receipts of the payments, he can escape all tax by giving away his right to income in advance of payment. If the taxpayer procures payment directly to his creditors of the items of interest or earnings due him, see Old Colony Trust Co. v. Commissioner, *supra*; Bowers v. Kirby Lumber Co., 284 U. S. 1, or if he sets up a revocable trust with income payable to the objects of his bounty, §§166, 167 Revenue Act of 1934, Corliss v. Bowers, *supra;* cf. Dickey v. Burnet, 56 F. (2d) 917, 921, he does not escape taxation because he did not actually receive the money. Cf. Douglas v. Willcuts, 296 U. S. 1; Helvering v. Clifford, 309 U. S. 331 (23 A. F. T. R. 1077).

"Underlying the reasoning in these cases is the thought that income is 'realized' by the assignor because he who owns or controls the source of the

> income also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants. *The taxpayer has equally enjoyed the fruits of his labor or investment and obtained the satisfaction of his desires whether he collects and uses the income to procure those satisfactions, or whether he disposes of his right to collect it as the means of procuring them.* Cf. Burnet v. Wells, *supra.*" (Italics supplied.)

It will be noted that the Supreme Court indicates above that where "the enjoyment" (of income) "is consummated by" "the taxpayer's personal receipt of money or property" such taxpayer is clearly taxable on the income enjoyed. Here appellant's wife enjoyed her half of said fee accounts receivable by receiving "property" from appellant in lieu thereof and she should be taxed on her half of said fees the same as if she had collected them.

Such a taxable event takes place when a property settlement is made and a husband transfers corporation stock, on which an unrealized increment has occurred, to his wife in consideration of her release or transfer of her interest in other property and in satisfaction of his obligation to support her. (*Commissioner v. Mesta*, decided by the United States Circuit Court of Appeals, Third Circuit, on November 25, 1941, reversing 42 B. T. A. 933).

Such a taxable event occurs in the case of a gift. (*Horst* and *Eubank* cases, 311 U. S. 112, 61 S. Ct. 144; 311 U. S. 122, 61 S. Ct. 149.)

The most common taxable event where a cash basis taxpayer realizes taxable ordinary income, although he does not collect the income himself, is where the payment of income is made directly to a creditor of the taxpayer. (*Old Colony Trust Co. v. Commissioner,* 279 U. S. 716, 49 S. Ct. 499; *Harrison v. Schaffner, supra.*)

Another type of taxable event is where a corporation retires its bonds at a lesser price than at which they were issued. (*U. S. v. Kirby Lumber Co.,* 284 U. S. 1, 52 S. Ct. 4.)

Another type of taxable event is where accrued earnings are transferred to another for cash; the "commuted payment" "replaced the future income with cash." (*Helvering v. Smith,* 90 F. (2d) 590 (C. C. A. 2); *Doyle v. Commissioner* (C. C. A. 4), 102 Fed. (2d) 86.)

Another instance of a taxable event which is not a technical sale or exchange is the case of *Helvering v. Elverson Corp.,* 122 Fed. (2d) 295 (1941) (C. C. A. 3), where the Court said:

> "Whenever anyone surrenders a thing of value for another thing of value, the surrender will for tax purposes ordinarily close the transaction by which he acquired the thing surrendered."

Certainly in this case appellant's wife surrendered things (her one-half of the earned but uncollected income) of value for other things of value and appellant did likewise. It is difficult to see why this reciprocal surrender of

things of value for other things of value is not a taxable event whereby gain or loss is immediately recognized. (Also see *Mesta* case, *supra.*)

Appellant assumed his wife's 1934 and 1935 income taxes as a part of the consideration for the transfer to him by her of her one-half interest in said earned but uncollected income. Her obligations were thus satisfied just the same as the husband's obligation was satisfied in the *Mesta* case, *supra.* This fact alone would make her taxable on her half of said earned income.

(c) Appellant Is Not Taxable on Any Part of the Wife's One-half of Said Fees Unless He Acquired Such Half for a Valuable Consideration, in Which Event He Is Only Taxable to the Extent, if Any, by Which the Collections Therefrom Exceed the Consideration Paid by Him to Her.

Since appellant's wife is taxable on her half of said fees unless she disposed of such half in a taxable transaction, conversely, appellant is not taxable upon any part of the collections thereof unless he acquired said half for a valuable consideration—in effect a purchase. Then he is taxable only upon the amount of $2,377.57 by which the collections exceeded the purchase price paid. If no sale, exchange or taxable disposition occurred the wife is still taxable upon her half of such collections.

VII.

The "Walz Case," Which Was Incorrectly Decided by the Board of Tax Appeals, Has Resulted in Incorrect Decisions by the Board in the "Mesta Case" and the "Crosby Case" and the Lower Court in This Case.

(a) The Walz Case.

At the time the lower court decided this case, only two cases were cited by the appellee as authority for the proposition that no gain or loss is recognized to either spouse in a property settlement, viz., *Walz v. Commissioner,* 32 B. T. A. 718, decided in 1935, and not appealed, and *Mesta v. Commissioner,* 42 B. T. A. 933, decided on October 10, 1940, and appealed to the United States Circuit Court of Appeals, Third Circuit, which handed down its opinion reversing the Board on November 25, 1941 too late to be considered by the lower court in deciding the present case.

Because of the reversal of the Board in the *Mesta* case by said Third Circuit Court, the *Walz* and *Mesta* cases, *supra,* no longer support the theory that no gain or loss is recognized to either spouse when a property settlement is made between them. On the contrary, the *Mesta* case is now authority for the proposition that gain or loss is recognized to the spouse who actually has a gain or loss in the transaction. Appellant believes that the lower court would have reached a different conclusion in this case had it had the benefit of the Third Circuit Court's decision in said *Mesta* case.

In the *Walz* case, *supra,* a husband in a property settlement transferred his community half interest in corporation stock to his wife and in addition agreed to pay her a

certain sum of money. In return the wife gave up her half of all other community property to the husband. The corporation stock at the date of settlement was worth less than the community cost thereof and the husband claimed a loss on 100% of the difference between cost and market. The Board held no gain or loss occurred because there was a "division" not "sale" or "exchange" involved.

A careful analysis of this case, which was not reviewed by the Board as a whole or appealed, shows that both the Division deciding the case and the taxpayer were wrong. Since the taxpayer husband only transferred his community one-half of the stock to his wife (she already owned one-half thereof) his loss was only one-half of that claimed by him. But Walz did sustain a loss of one-half of the claimed amount because he "disposed" of his half and received in return his wife's half of other property. *(Mesta* case, *supra* and *infra.)* He surrendered a thing of value for another thing of value, which closed the transaction by which he acquired his half of the stock, and gain or loss then occurred. *(Helvering v. Elverson Corp., supra.)*

(b) The Mesta Case.

In the *Mesta* case, a Division of the Board again held that a property settlement between husband and wife was a division of property and that neither realized gain or loss by such transaction.

In that case the husband in a property settlement transferred certain corporation stock and some other miscellaneous separate property to his wife, and she gave up to him her interest in the home which was owned by her and Mesta as tenants by the entirety; each spouse released any claim they might have to the property of the other; and

she acknowledged that the delivery of the securities and property mentioned above was "in full settlement of all claims and demands for her maintenance and support."

The corporation stock in question had a cost of $7,574.56 and a market value of $156,975.00 at the time of settlement. The Commissioner claimed that Mesta had gain, profit or income of $149,440.44 by the transaction. Mesta claimed he had no gain by the transaction.

The Board held that Mesta realized no gain, profit or income, because there was

> "Merely a property settlement between a man and his estranged wife—in other words a division of property."

The Board, in deciding the *Mesta* case, probably relied upon the *Walz* case, *supra,* but in any event the principle of the two decisions was the same, viz., that no gain or loss occurs in a property settlement because it is a division of property.

The *Mesta* case, unlike the *Walz* case, was appealed and on November 25, 1941, the United States Circuit Court of Appeals for the Third Circuit handed down its opinion reversing the Board and said in part as follows:

> "Had the stock not been transferred he would not have achieved a taxable gain because the economic gain would have been unrealized. *The disposition of the stock was the taxable event in the case at bar.* This is so even though Mesta may not have received payment in money or property from Mrs. Mesta. The point which we are trying to make is clearly established by the decision of the Supreme Court in Helvering v. Horst, 311 U. S. 112, wherein Mr. Justice Stone said: 'Admittedly not all economic gain

of the taxpayer is taxable income. From the beginning the revenue laws have been interpreted as defining "realization" of income as the taxable event, rather than the acquisition of the right to receive it. And "realization" is not deemed to occur until the income is paid. But the decisions and regulations have consistently recognized that receipt in cash or property is not the only characteristic of realization of income to a taxpayer on the cash receipts basis. *Where the taxpayer does not receive payment of income in money or property realization may occur when the last step is taken by which he obtains the fruition of the economic gain which has already accrued to him.'* The case cited involved *a transfer of income* and not a transfer of *income-producing property* but it supplies an illuminating analogy.

"The Board of Tax Appeals concluded that there was no way to measure the amount or value received by Mesta from the disposition of the stock. Section 22(a) of the Revenue Act of 1934, c. 277, 48 Stat. 680, provides that '"Gross income" includes gains * * * from * * * sales, or *dealings in property,* whether real or personal * * *.' Section 22(a) states, 'In the case of a sale or *other disposition of property,* the gain or loss shall be computed as provided in Section 111.' Section 111(a) provides, 'The gain from the sale or *other disposition of property* shall be the excess of the amount realized therefrom * * *,' and subdivision (b) provides, 'The amount received from the sale or *other disposition of property* shall be the sum of any money received plus the fair market value of the property (other than money) received.' Section 112 provides, 'Upon the sale or exchange of property the entire amount of the gain or loss, determined under §111, shall be recognized * * *.'

> "We think there can be no doubt that Congress intended a measurement of values under the circumstances indicated by the statutes quoted, notwithstanding difficulties in determining those values. *In the case at bar there is a gain in the value of the stock and an event whereby that gain was realized.* * * *" (Italics supplied.)

The Circuit Court reiterated the familiar principle heretofore set forth in this brief, that the *disposition,* regardless of the manner thereof, of earned or accrued income or of unrealized capital increment results in a "taxable event" which causes the unrealized income or increment to become realized. The Court rejected the theory that because a property settlement agreement is a division of property no "taxable event" occurs and no gain or loss is realized. The appellate court's reversal of the *Mesta* case was in principle also a reversal of the *Walz* case and the *Crosby* case, *infra,* and the lower court's opinion in this case.

(c) The Crosby Case.

Crosby v. Commissioner, 46 B. T. A....., was decided on February 18, 1942. In that case the taxpayer had transferred a small amount of property to his wife and had agreed to pay her monthly cash payments which were styled "alimony," in the written property settlement agreement, but which he claimed were payment for her community half interest in certain earned but uncollected commissions. The Board held that the payments were "alimony" and not payment for the wife's one-half of the commissions; that, on the authority of the lower court's opinion in the present case, no gain could have occurred to the wife when she assigned her interest in such commis-

sions to her husband because there was merely a division of property; and finally that even if he were entitled to recover the cost of property which he had transferred to his wife he had not established the "cost" or "basis" thereof.

An appeal has been taken in the *Crosby* case and such appeal will ultimately come before this Court. The Board in the *Crosby* case made no mention of the reversal of the *Mesta* case, *supra,* by the Third Circuit Court, probably because it was not called to its attention, having been decided after the submission of the *Crosby* case.

VII.

The Lower Court's Decision Is in Direct Conflict With Horst, Eubank and Schaffner Cases.

The decision by the lower court in this case is exactly the same in principle as the *dissenting opinion* of Justice McReynolds in the *Eubank* case, *supra,* in which he cited with approval the following language from the Circuit Court's decision which was reversed by the Supreme Court in said case:

> "'* * * *But when a taxpayer who makes his income tax return on a cash basis assigns a right to money payable in the future for work already performed, we believe that he transfers a property right, and the money, when received by the assignee, is not income taxable to the assignor.'" (Italics supplied.)

Justice McReynolds said further in his *dissenting opinion:*

> "A mere right to collect future payments, for services already performed, is not presently taxable as 'income derived' from such services. It is property which may be assigned. *Whatever the assignor re-*

> *ceives as consideration may be his income;* but the statute does not undertake to impose liability upon him because of payments to another under a contract which he had transferred in good faith, under circumstances like those here disclosed." (Italics supplied.)

The Government's contention in the present case, which was approved by the lower court, is exactly the same as the principle which was rejected by the Supreme Court in the *Eubank* and *Horst* cases, *supra.*

The lower court in this case casually waived aside the *Horst* and *Eubank* cases, *supra,* with the statement that no gift is involved herein but in the *Schaffner* case, *supra,* the Supreme Court did not so restrict such decisions when it said:

> "Decision in these cases (Horst and Eubank) was rested on the principle that the power to dispose of income is the equivalent of ownership of it and that the exercise of the power to produce its payment to another, *either to pay a debt or to make a gift,* is within the reach of the statute taxing income 'from any source whatever.'" (Italics and parentheses supplied.)

This language establishes the broad general principle that no owner of earned but uncollected income can transfer the same by any conceivable device and relieve himself or herself from paying the income tax thereon. Fairly construed, this language means that whenever an owner of earned or accrued income exercises "the power to procure its payment to another," either for or without consideration, the assignor or transferor is held still taxable

on the income itself when collected, if no valuable consideration is involved, or is taxable on the consideration received in lieu of said income, if the transfer is one for valuable consideration. But in neither event is the assignee or transferee taxable thereon, except that an assignee for valuable consideration is taxable on any excess of the amount collected over the amount or value of the consideration transferred.

A correct statement of applicable law is contained in the case of *Van Meter v. Commissioner* (C. C. A. 8), 61 Fed. (2d) 817, 11 A. F. T. R. 1002, cited with approval by the Board in *Horst v. Commissioner,* 39 B. T. A. 757, at page 760, as follows:

> "* * * It may be true that income already earned is transferable as a species of property, but that has no effect upon the power and intention of Congress to tax income to the earner. The earner may, in a legally binding way, dispose of his earnings, whether they are already earned or are to be earned, without affecting in the slightest manner his status as earner thereof and his resulting liability for taxation thereon as income."

In the *Van Meter* case the Court held that an insurance agency corporation and not its stockholders was taxable on renewal commissions assigned to such stockholders, who did not own them when earned but did own them at the time collected. There may have been and probably was a legal consideration for the assignment, but there was no cash or property received and returned as income by the corporation in lieu of the commissions. The same type of

renewal commissions were involved in the *Van Meter* case as in the *Eubank* case, *supra*. Such renewal commissions are the same in principle as the income involved in this case.

Perhaps a clearer restatement of the principle announced in the *Horst* and *Van Meter* cases, *supra,* would be as follows:

> Ownership at the time income is earned or accrued determines the person who is taxable thereon, and ownership at the time of collection is immaterial.

The position of the Commissioner in this case which was affirmed by the lower court is in effect as follows:

> Ownership at the time income is collected determines the person who is taxable thereon, and ownership at the time said income was earned or accrued is immaterial.

The lower court may have been confused in this case by the fact that the husband (appellant) performed the actual services for which the legal fees were paid. However, the community was the "earner" not appellant and prior to the property settlement, he was never the owner of more than his half of such earnings, which he owned as a member of the marital community. As the U. S. Supreme Court said in the *Poe v. Seaborn* case, *supra:*

> "The earnings (of the husband) are never the property of the husband, but that of the community." (Parenthetical clause supplied.)

Also see *Goodyear* case, ***supra.***

IX.

If the Property Settlement Was a "Tax-Free Exchange" Transaction on Which No Gain or Loss Is Recognized, Appellant Only Realized Income of $1,257.39 When He Collected His Wife's One-half of the Accounts Receivable, and His Wife Realized Either No Income at All or Income of $8,201.73.

Up to this point the brief has been devoted to demonstrating that appellant's wife realized income at the exact moment when she disposed of her half interest in said accounts receivable, representing legal fees earned but not collected, regardless of whether appellant ever collected said account, and that appellant realized income only to the extent of the difference between his cost of property transferred to his wife and the $26,014.23 collected from her half of said accounts. Now appellant will show, in the alternative, that even though his wife had no "taxable income" by the disposition of her half interest in said accounts, or in other words, even if the property settlement agreement was a transaction on which no gain or loss was recognized to either spouse, nevertheless, appellant under this theory only had "taxable income" to the extent of $1,257.39 and not $26,014.23 when he collected his wife's half interest in said accounts.

The income tax law provides for an exact determination of the amount of gain or loss on every transaction, but provides that in certain instances the actual gain or loss, although clearly "realized" shall not be "recognized" for income tax purposes. However, when any such gain is "realized" but not "recognized" the taxpayer is required to use the cost basis of the property transferred as the cost or basis of the property acquired. This in effect

defers the payment of income tax on the gain until the property acquired in the transaction is subsequently disposed of. Correctly interpreted this principle is all that the *Walz* case, *supra*, stands for as is shown by the following quotation therefrom:

> "Gain or loss on the property thus divided would depend upon its subsequent disposal by the parties."

Thus Section 111 of the Revenue Act of 1934 provides the method for determining the gain or loss "realized" from the sale or "other disposition of property" but provides that the gain or loss so determined shall only be recognized to the extent provided for in Section 112. Section 112 provides that the entire gain or loss shall be "recognized" except in the case of certain exchanges on which Congress thought that the gain or loss should be deferred for income tax purposes until the new property is disposed of. Section 113(a)(6) provides that in the case of certain "tax-free exchanges," since no gain or loss is recognized, the cost of the new property shall be the same as the cost of the old property for the future determination of the gain or loss when the new property is disposed of.

Assuming only for the purpose of argument that no gain or loss was recognized to either appellant or his wife by the property settlement transaction, and applying Sections 111, 112, and 113, *supra*, it is then apparent that appellant would be entitled to use, as his cost of the half of the accounts receivable and other property acquired from his wife the cost of his one-half interest in the property transferred to her, plus the amount of cash paid out by him for her, which would be $38,610.41 plus $8,201.73, or a total of $46,812.14. [R. 59.] Section 113(a)(6),

Revenue Act of 1934; *Wells Fargo Bank & Union Trust Co. v. McLaughlin,* 78 Fed. (2d) 934 (C. C. A. 9).

In addition to her interest in accounts receivable having a face and market value of $26,014.23, he received her interest in other property having a market value of $23,-175.48, making a total of $49,189.71 received from his wife. [R. 58.] Therefore, his cost or basis of her half of the accounts receivable would be $\frac{\$26,014.23}{\$49,189.71}$ of $46,-812.14 or $24,756.84.

When he collected his wife's one-half interest in the accounts receivable he received $26,014.23. Deducting his cost of $24,756.84 from $26,014.23 would then give him a "recognized" income or profit of $1,257.39 from such collections.

This compares with the profit of $2,377.57 which has already been demonstrated that appellant actually "realized" out of the transaction. The "realized" but not "recognized" difference of $1,120.18 ($2,377.57 minus $1,257.39) would not be "recognized" until appellant disposed of the remaining property which he received from his wife. Appellant's cost of the remaining property would be $\frac{\$23,175.48}{\$49,189.71}$ of $46,812.14 or $22,055.30; the market value of the other property received from his wife was $23,175.48, making a difference of $1,120.18, which would represent profit actually "realized" by him but not "recognized" for income tax purposes until he disposed of such remaining property.

Under the "tax-free exchange" theory, appellant's wife received his half interest, having a market value of $37,-

000.00, in certain property and received cash payments for her benefit of $8,201.73, or a total of $45,201.73. [R. 59.]

Her cost of the half interest in property passing from her to appellant was $27,309.52, representing no cost for her half interest in the accounts receivable and a cost of $27,309.53 for her interest in other property. [R. 59, 60.] Therefore, she actually "realized" a profit of $17,892.20 on the transaction as demonstrated in the first part of the brief. However, either no part of this profit would be "recognized" for income tax purposes until she disposes of the half interest in the property received from her husband; or, in the alternative, not more than $8,201.73 would be "recognized," being the amount of her tax liability assumed and paid by appellant. This debt assumption of $8,201.73 might be treated as "other property or money" which is the exception (Sec. 112(c) of the Revenue Act of 1934) to the general rule that no gain is recognized from certain tax-free exchanges. In any event under this theory appellant's wife would be taxable on a maximum of $8,201.73 and the balance of the "realized" profit of $17,892.20 would not be "recognized" until she disposed of the one-half interest in other property received from appellant.

Thus even if the property settlement transaction were one on which no gain or loss is "recognized" to either spouse, the correct application of the income tax laws would result in both spouses "realizing" exactly the same gain as if gain or loss were "recognized" on the transaction. but only a portion of the income actually "realized" would be "recognized" until the spouses disposed of the remaining property interests received by them in the property settlement.

8. Conclusion.

Upon consideration of the foregoing it is submitted that appellant either received no taxable income when he collected the half of said fees acquired from his wife in the property settlement or in the alternative he received income not in excess of $2,377.57 when he collected said half. The decision of the District Court is erroneous and should be reversed.

Respectfully submitted,

Todd W. Johnson,
In Propria Persona.

argued by Mr. Horner.

No. 10214.

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IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

TODD W. JOHNSON,

Appellant.

vs.

UNITED STATES OF AMERICA,

Appellee.

APPELLANT'S REPLY BRIEF.

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APPELLANT'S REPLY BRIEF.

Statement.

Briefs already filed by appellant and appellee set forth the law and facts involved herein but appellant wishes to point out two inadvertent erroneous statements of facts in appellee's brief, as follows:

On page 1 appellee states that appellant paid the tax in controversy in 1936, whereas he paid such tax on June 11, 1938. [R. 84.]

On page 5 appellee states that in the event taxpayer is successful in his contentions in this case, the refund should be limited to the difference or balance between the defi-

ciency originally determined by the Commissioner and the overpayment determined in favor of appellant's wife which was credited to or against said deficiency. Actually appellant and the Commissioner agreed that any such refund or "recovery on the community property basis shall be limited to the net amount after giving effect to the resultant tax due from his wife and barred from assessment against her by the Statute of Limitations." [R. 85.] This would mean that any refund of tax to appellant would be reduced by the deficiency tax which his wife would owe on $17,892.20 additional income (not $26,-014.23) if appellant's contentions on pages 21 to 25, inclusive, of his opening brief are sustained.

ARGUMENT.

At the outset appellant wishes to emphasize that this is the first time the particular question involved herein has been presented to any Appellate Court and the decision of this Court will be of unusual significance.

In this reply brief appellant will follow the sequence of appellee's brief as nearly as possible in endeavoring to show the unsoundness of appellee's arguments.

Appellant's Ownership of His Wife's Half of the Community Fees at the Time He Collected Them Does Not Make Him Taxable Thereon.

1. Appellee first argues that, "as a general rule compensation for personal services is taxable to the one who earned it and controlled its disposition", but "an exception is made in the community property states in that the wife's technical ownership of a one-half interest in the husband's earnings makes that portion taxable to her". (Br. 7.)

Actually the general rule is that the person (or corporation) who *owns the right to receive such compensation for personal service at the time it is earned* is the one taxable thereon. There are two exceptions to this rule, and only two, of which appellant is aware, viz., first, if a person assigns his future earnings to another person, *without a full consideration in money or property*, the earner-assignor and not the assignee (owner of the income when earned) is taxable on the earnings when they are subse-

quently earned and collected (*Lucas v. Earl,* 281 U. S. 111; *Helvering v. Horst,* 311 U. S. 112; *Helvering v. Eubank,* 311 U. S. 122); *Somerville, Van Every* and *Van Dyke* cases, *infra,* and second, if a person assigns *past uncollected earnings* for a full consideration in money or property, the original owner-assignor is relieved from income tax on the income assigned when it is collected—*but in lieu thereof such original owner is taxable on the consideration received* in exchange or payment for the assigned income. *Helvering v. Smith,* 90 Fed. (2d) 590 (C. C. A. 2); *Doyle v. Com.,* 102 Fed. (2d) 86 (C. C. A. 4).

In numerous instances compensation for personal services is not earned by nor taxed to the person who actually performs the services. For instance one law partner may perform the services for which a certain fee is paid but he does not earn and is not taxable on the fee. The partnership earns the fee and he is taxable only on his partnership portion thereof. An officer or employee of a corporation may perform a service for which payment is made to the corporation, but the officer or employee does not earn and is not taxable on the payment to the corporation but instead he earns and is taxable on the salary he receives. Likewise, in a community property state, a spouse, who performs a service for which a legal fee is paid or payable to the marital community or partnership, does not earn and is not taxable on the fee. The marital partnership earns the fee and each spouse is taxable on half thereof as a member of the marital community.

Therefore, under the general rule and not as an exception thereto, the wife is taxable on one-half of the community income from the husband's services because she

owns one-half thereof when the service is performed. *Poe v. Seaborn,* 282 U. S. 101.

When one spouse dies the entire marital community is administered upon and the executor *owns and is taxable on all of the income* during the administration and the surviving spouse owns and is taxable on no part thereof. (*Commissioner v. Larson,* decided by this Court on October 21, 1942.) The *Larson* case involved only income on community property (not income for personal services) and such income was *earned or accrued and collected* during the administration. Any earnings or income, which were either earned or accrued prior to the death of the deceased spouse, were taxable half to the decedent in his last income tax return and half to his wife, even though collected during the administration of the estate. *Helvering v. Enright,* 312 U. S. 636.

2. Appellee next argues that by agreement appellant and his wife could and did make both the future and past (but uncollected) earnings of appellant his separate property and, since appellant owned his wife's half of said past earnings when he collected them, he was taxable on his wife's half thereof as well as his own, because the exception to the general rule (taxing one-half to each spouse) no longer is applicable.

Appellant has already shown that the taxation of half the community income to each spouse is not an exception to but is the general rule, viz., income is taxable ultimately to the one who owns it at the time it is earned. It should be borne in mind that the "past earnings" were not his past earnings, but were the past earnings of the marital community or partnership, and were merely community property in which each spouse had a vested one-

half interest. As the United States Supreme Court said in *Poe v. Seaborn, supra:*

> "The earnings (of the husband) are never the property of the husband, but that of the community." (Parenthetical clause supplied.)

If one law partner acquires for cash or property his law partner's half of a particular fee in a case on which his law partner had done no work, it cannot be correctly said that he received and collected his past earnings since the partnership, not he, earned the fee. Certainly the acquiring law partner could recover his cost of the share in the fee acquired from his partner before he received taxable income. *Smith* and *Doyle* cases, *supra.*

Of course appellant owned his wife's half of said past earnings when he collected them, but he acquired them in a capital transaction as will hereafter be pointed out. However, he did not own them as his "separate property" but as his "property". The term "separate property" is used to distinguish property owned by each spouse from that owned by the marital community. Since the community was dissolved by the agreement the fees or past earnings were simply his "property". This point is brought out to emphasize the fact that the husband and wife relationship has no bearing on this case. The matter should be considered the same as if any two unmarried persons who each owned half of certain property, including legal fees earned but not collected, make an agreement dividing it equally between themselves. This is so because the spouses can only make such contracts "which either might if unmarried". *California Civil Code*, Sec. 158.

As property appellant's wife could and did convey or surrender her half to appellant; he owned her half thereof

and she did not when he collected said fees; but his ownership *at the time of collection* does not establish that he is taxable on her half of said fees. Ownership by the wife *at the time the marital partnership earned the income* makes her taxable either on her half itself when collected or, if she has surrendered or transferred her half for money or property, on the consideration received in lieu thereof. See also the following cases which held that the *owner of the income at the time it is earned* must pay the tax thereon when it is collected. *Albert Houston v. Commissioner of Internal Revenue,* 31 B. T. A. 188; *Delvin v. Commissioner,* 9th Circuit, 82 Fed. (2d) 731, 17 A. F. T. R. 690; *Asher v. Welch* (D. C. Cal.), 28 Fed. Supp. 893, 23 A. F. T. R. 664, affirmed 111 Fed. (2d) 59.

In the *Horst* and *Eubank* cases, *supra,* and *Van Meter v. Com.,* 61 Fed. (2d) 817, the donee or assignee of earned income was clearly the owner thereof when it was collected. Such income was the "separate" property of the wife or other donee, but the assignor or donee (original owner) was held taxable thereon. In the *Smith* case, *supra,* the continuing law partners (assignees for full consideration in money or property) were the owners of the assigned share of fees when the fees were collected but the retiring law partner was held taxable on the consideration received by him in exchange for said share.

If appellant's wife made a gift or a transfer, without a valuable consideration, of her half of said fees, she remains taxable on her half. *Horst* and *Eubank* cases, *supra.* If she received an adequate consideration therefor in money or property she is taxable on the consideration received but not on the fees when collected. *Smith* and *Doyle* cases, *supra.* Conversely appellant is entitled to de-

duct the consideration paid by him from her half of said fees before paying any income tax thereon. If appellant's wife did not transfer her half of the fees in question to appellant for a consideration in money or property (which she actually did) or as a gift, she must have transferred it to him in discharge or satisfaction of some marital obligation and is taxable on the market value of her half under the rule of *Commissioner v. Mesta,* C. C. A. 3, 123 F. (2d) 986. In that case Mesta had a small cost for the property transferred to his wife in satisfaction of her marital right to support and only the difference between the cost and market value of the property was taxable to him. Here the wife had no cost for her half of the fees and is taxable on the full market value thereof. (See pages 18-19 of this brief for further analysis of the *Mesta* case.)

3. The appellee next argues that the following cases decided by this Court are decisive of the present case: *Van Every v. Com.,* 108 F. (2d) 650; *Boland v. Com.,* 118 F. (2d) 622; *Van Dyke v. Com.,* 120 F. (2d) 945, and *Somerville v. Com.,* 123 F. (2d) 975.

The appellee frankly admits, as it must, that none of these cases involved *income earned before and collected after the agreement* (past earnings) but on the other hand each case involved *income both earned and collected by the husband after the marital partnership was* dissolved by agreement (future earnings). As pointed out on pages 14 to 18, inclusive, of appellant's opening brief these four cases merely hold that, when the community is dissolved by agreement each spouse is *emancipated* and the subsequent personal earnings of each former spouse are taxable in full to him or her because each spouse then owns the income he or she earns *at the very time it is earned.* This is exactly what happens when a law or business partner-

ship is dissolved, *viz.*, each partner thereafter is taxable on his personal earnings, but the past earnings of the partnership are still taxable to the partners in accordance with their respective partnership interests and not according to who performed the service for which the payment is received. Furthermore, when one partner transfers his share of earned but uncollected fees to another partner, in settlement or dissolution of the partnership, the transferring partner is taxable on the consideration he receives and the acquiring partner is only taxable on the difference, if any, between the amount paid therefor and the amount collected therefrom. *Smith* and *Doyle* cases, *supra*.

Appellant's Wife Is Either Taxable on Her Half of the Past Earnings of the Community or Upon the Property Which She Received in Exchange Therefor.

But, says the appellee, although appellant's wife owned half of said fees prior to the agreement and would have been taxable thereon had they been collected prior thereto, the tax burden is shifted from her to appellant because he and not his wife owned her half when the *receipt* of income took place (styled by appellant, the taxable event). (p. 11.)

Appellee cites *Anderson v. Com.*, 78 F. (2d) 636 (C. C. A. 9), and *Poe v. Seaborn*, 282 U. S. 101, as authority for this argument but neither case supports it. The *Anderson* case actually involved only the income from community property accumulated prior to 1927 by a California husband and wife and not past earnings of the marital community from the services of the spouses.

Prior to 1927 a California wife had only an expectancy and not a vested interest in community property. *U. S. v. Robbins,* 269 U. S. 315, 46 S. Ct. 148. Anderson and his wife made an oral agreement that they would own such property as tenants in common and not as community property. This Court merely held that the agreement was effective to make such property tenancy in common instead of community property and therefore the husband was not taxable on all but on only one-half of the income. This is shown by the closing sentence in the opinion of the Board (33 B. T. A. 94) on the remanded case, as follows:

> "Upon our amended findings of fact and in view of the opinion of the Circuit Court of Appeals, we are of the opinion that petitioner is liable to income tax upon only one-half of the *income from the properties* owned by petitioner and his wife during the year in question." (Emphasis supplied.)

Poe v. Seaborn is the original case which holds that where a wife has a vested interest in the marital community, earnings of both spouses are taxable one-half to each spouse. There was no assignment of either past or future earnings involved in that case. The court held that the earnings of a particular spouse are never his or hers so long as the community exists but are that of the community. In other words, the particular spouse does not earn the income, the marital partnership earns it.

On page 13 of its brief, appellee has misquoted appellant's position to be as follows:

> "The accrual of the right to income is the taxable event for a taxpayer reporting on the cash basis and since the earnings in question accrued as community income they must be taxed as such."

Actually appellant's position is that the owner of income at the time of accrual is the one who must ultimately pay income tax thereon regardless of whether or not he owns it when it is collected. The taxable event to a cash basis taxpayer is not the accrual but the collection (receipt), unless the original owner *has* sold or assigned the income for property or money in which event the *receipt of the consideration* is the taxable event.

If appellant has collected an amount in excess of the consideration which he paid his wife for her half interest such excess is taxable to him. To this extent his receipt or collection of her half of said fees is a "taxable event".

The "taxable event" to appellant's wife was her receipt of his half of certain property in exchange for her half of said fees. She was taxable at that instant upon the value of said property so received regardless of when, if at all, appellant collected her half of said fees. For instance in the *Smith* and *Doyle* cases, *supra,* the Court did not inquire when or whether the remaining partners collected the retiring partner's share of the fees which he conveyed to them. The taxable event to the retiring partner, who reported his income on a cash basis, was not the receipt or collection by the remaining partners of his share of the fees, but the receipt by him of the consideration paid to him for his share of said fees.

In the *Smith* case, the Court said:

> "Except for the 'purchase' and release, all his collections would have been income; the remaining partners would merely have turned over to him his existing interest in earnings already made. As he kept his books on a cash basis, it is true that he would have been taxed only as he received the accounts in

driblets, but he would have been taxed upon them as income. The 'purchase' of that future income did not turn it into capital, (not in his hands but it was capital in the hands of the acquiring partners) any more than the discount of a note received in consideration of personal services. (The note would be capital in the hands of the purchaser.) The commuted payment merely replaced the future income with cash. Indeed, this very situation was suggested in Bull v. United States, *supra,* 295 U. S. 247, at pages 256, 257, 55 S. Ct. 695, 698. 79 L. Ed. 1421, and dealt with as we say. Nobody would suggest that the sale of a declared dividend payable in the future turns the cash received into capital." (Parenthetical clauses supplied.)

In *Bull v. United States,* 295 U. S. 247, the Court considered a similar hypothetical situation in the following language:

> "* * * Let us suppose Bull had, while living, assigned his interest in the firm, with his partners' consent, to a third person for a valuable consideration, and in making return of income had valued or capitalized the right to profits which he had thus sold, had deducted such valuation from the consideration received, and returned the difference only as gain. We think the Commissioner would rightly have insisted that the entire amount received was income."

In *King v. Com.* (C. C. A. 5), 69 F. (2d) 639, a legal fee was earned by a marital community before it was dissolved by the death of the wife and the fee was col-

lected after her death by the husband. The Commissioner claimed the husband was taxable on all the fee instead of his half. The Court held that the husband was taxable only on his half of the fee and the wife's estate was taxable on the other half because *she owned one-half of said fee at the time it was earned* by the marital community.

Let us suppose that in the present case appellant has surrendered or assigned his half of said fees to his wife and she had retained her half. Then such fees would have been her "separate property" when collected. Would the Government then say that the husband was relieved from tax on his half thereof? Of course not—but every argument the Government makes in this case would be equally applicable, except that she did not actually perform the service which is immaterial.

Or let us suppose that in the settlement appellant and his wife each retained their halves of the fees, and after the settlement the appellant exchanged a piece of his real estate or paid her money for her half. Then certainly under elementary income tax law she would have been taxable on the consideration received and appellant could recover the consideration paid by him before he realized any income. *Smith* and *Doyle* cases, *supra*. This is exactly what occurred in the property settlement except everything was accomplished in one transaction instead of two transactions as in this hypothetical example.

Appellant Is Entitled to Recover the Cost of the Property He Conveyed to His Wife in Exchange for Her Half of Said Fees.

1. Appellee next argues that appellant is not entitled to recover his cost of property transferred to his wife in exchange for or in lieu of her half of said fees, because the "Expenditures in connection with the dissolution of marriage constitute personal expenditures and as such are not deductible," (App. Br. p. 7.) With this general rule, taken from cases decided in separate property states. where the wife only has a right to alimony, appellant does not quarrel. However, in a community property state there are two classes of rights which must be settled:

(a) Any marital rights which either spouse has against the other, including the right, if any, to support by either a wife or a husband from the other, must be settled by agreement or by the Court.

(b) The community property of the spouses must be divided either by agreement or by the Court.

In this case the spouses settled both rights by agreement. They settled their marital rights, exclusive of dividing their community property, by the husband agreeing to pay his wife $6,000.00 at the rate of $500.00 per month [Finding VII, R. 53.] This was a "personal expenditure in connection with a dissolution of marriage" and appellant does not claim he is entitled to recover or offset it against the half of the fees acquired from his wife. Whatever a husband pays a wife in money or property, either at the time of settlement, or afterwards for her support or other marital rights (except property rights) is such a personal expenditure.

However, the transfer by appellant to his wife of his half of certain joint and community properties, was not for her release of any marital rights, but for half of said fees of $52,028.45 and her half of certain other property. As found by the lower court the $6,000.00 cash payment made by appellant "was in full satisfaction of and constituted a complete discharge of the rights, if any, which his wife had to receive support, maintenance and alimony." [R. 53.][1] Therefore the transfer to her of his half interest in said properties could only have been for her half of said fees and other property. Had the half interest in said properties transferred by appellant to his wife been disproportionate in value to the half interest in the fees and other property acquired by him from her, the difference might well have constituted a "personal expenditure" and not the cost of acquiring his wife's half of said fees and other property and the lower court would have so found.

Appellee cites only two cases in support of this point (other than those of this Court relating to "emancipation" of the spouses by agreement), *viz.*, *Gould v. Gould,* 245 U. S. 151, and *Ullman v. Commissioner,* 6 B. T. A. 100, 102. The *Gould* case involved the question of whether cash payments of alimony were taxable to the wife and deductible by the husband for income tax. The Court held the payments were not taxable to the wife and not deductible by the husband. Appellant does not claim a deduction for the alimony which he paid his wife.

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[1]There was considerable testimony below on this point but because Finding VII [R. 53] was correct, appellant did not have any part of the transcript printed covering the testimony thereon and appellee caused only part thereof to be printed. [R. 94, 95, 96, 97, 111, 112.]

The *Ullman* case also involves alimony paid in 1922 by a California husband to his wife. He deducted the payments for income tax purposes and the Board held he could not do so. Since it *was not until 1927* that a wife in California had a vested interest in the community earnings and prior to that time the husband was taxable on all of the community earnings, this case simply applies the rule announced in the *Gould* case, *supra*.

2. The appellee next argues that no capital transaction is involved and says that the property transferred by appellant to his wife was simply the cost of freeing his past earnings from a prospective claim of his wife, and was not the cost of acquiring a capital item having a cost basis (p. 25). Appellant has already shown that the past earnings were not his but those of the marital partnership and that regardless of the nature of the transaction his wife is either taxable on the consideration received therefor or her half of the fees themselves. He will now show that a capital transaction was involved.

The Capital Transaction Involved.

The lower court in this case stated in its opinion in part as follows:

> "But here, the accounts receivable were original income and a capital transaction was not involved."

As set forth in appellee's brief the Board of Tax Appeals stated in a similar case (on authority of the lower

court's opinion in this case), *Crosby v. Commissioner,* 46 B. T. A. 323, 331:

> "The right received by the petitioner (taxpayer) was one to receive ordinary earnings, and not property acquired through capital expenditures."[1]

Many taxpayers and even the Commissioner of Internal Revenue often become confused as to a capital transaction when original income is involved. For examples see the quoted portions of the *Smith* and *Bull* cases on pages 11-12. Prior to the property settlement the wife's community half of the fees involved unquestionably was "original income" or "the right to receive original earnings" and remained such until or unless a "taxable event" transposed it into capital. Until "original income" becomes "realized" by collection or by assignment for a full consideration in money or property it does not become capital. *Mesta. Smith* and *Bull* cases, *supra.*

Appellee agrees with this rule on page 27 of his brief in the following language:

> "Earnings must be taxed as income before they attain the status of capital" but says appellee, "to allow the taxpayer (appellant) a cost basis for any portion of his earnings would permit the conversion of taxable income to capital without assessment of an income tax."

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[1]In the *Crosby* case the payments made by the husband were called alimony in the property settlement and were so held by the Board, although the husband claimed they were actually paid for his wife's one-half of certain "past earnings." If the payments were actually alimony then of course they were not the cost of acquiring his wife's half of "past earnings" of the marital community. In effect the Board in the *Crosby* case reiterates the erroneous position which it took in *Bigelow v. Commissioner,* 38 B. T. A. 377, which case it afterwards reconsidered, reversed and corrected in 39 B. T. A. 635, after this Court rejected such principle in the *Goodyear* case, *supra.*

If the wife were not taxable on her half of said fees, or upon the consideration she received from appellant, this argument might be persuasive, but since she is so taxable thereon *her half is thus converted into a capital asset in appellant's hands* and has a cost equivalent to the cost of the property exchanged therefor. Her half of said fees were never capital in her hands. The receipt by her of appellant's half of other property in exchange therefor was the "taxable event" which transposed her half into a capital asset in appellant's hands. The half interest of the properties acquired by her from appellant was then a capital asset in her hands. She was taxable on the market value thereof and such value then became her cost or basis, for determining gain or loss on the subsequent disposition of the half interest acquired by her.

The wife's half of said fees became a capital asset in appellant's hands because he exchanged his half of other property therefor. When he collected her half of said fees he realized gain or loss based upon the difference between his cost of the property exchanged and the value of her half of said fees acquired by him.

The discussion of the *Mesta* case, *supra,* on page 26 of appellee's brief, is confusing. For instance appellee says "It is not suggested by the opinion in that case that the transfer gave the taxpayer a cost basis for the stock." In the *Mesta* case the transferror of the stock was the taxpayer (husband) and not the transferee (wife). Here the transferee is the taxpayer (husband) and not the transferror (wife). Appellant does not claim that the transfer gave any cost to his wife (transferror) for her half of the fees transferred. He admits that, since she

"disposed" of her half of said fees, she was taxable *in full* on either her half of the fees or upon the consideration received because she had no cost. The court in the *Mesta* case did not consider nor decide what cost or basis the wife (transferee) had for determining the gain or loss upon her subsequent sale or disposition of the stock acquired by her from her husband, but it is obvious that it would be the market value thereof at the time she acquired it from Mesta. Likewise in this case appellant's cost or basis for determining gain or loss on his subsequent disposition (collection) of his wife's half of said fees was the market value of them when acquired by him.

On page 21 of its brief appellee argues that in the *Somerville* case, 123 F. (2d) 650, it could have been plausibly contended that his agreement to pay and payment to his wife of half of his future earnings for two years represented his cost of acquiring her half interest in his future earnings and therefore he was entitled to offset them against his future earnings for income tax purposes. The answer to this is that the wife's community right to half of the husband's earnings exists only so long as the marital community exists. She has no right to half of the husband's earnings after the community is dissolved by divorce, death or agreement. It would be just as logical to argue that when a two-man law partnership is dissolved one partner would have a right to a half share of the future earnings of the other partner.

3. Finally appellee argues that appellant already owned his wife's one-half of said fees, or had control and management thereof equivalent to ownership, so that he acquired nothing of value from his wife in the settlement when he "technically" acquired her half of said fees.

It suffices to say that this is exactly the same argument made by the Government in such cases as *Poe v. Seaborn, supra; U. S. v. Goodyear* (C. C. A. 9), 99 F. (2d) 523, and the many other cases where the Government contended that the husband in all community property states is taxable on all community income, and that all of the community property is taxable for Federal Estate Tax purposes in the estate of the husband. In all of these cases it was held that the wife had equal ownership with the husband, and that his management and control was merely as agent for the community and not for his own benefit.

However, even the husband's control or management *as agent* disappears when a divorce is imminent. The power of the husband to manage and control the community property terminates on dissolution of the marriage by divorce, 31 *C. J.* 181; *Barkley v. American Sav. Bank, etc. Co.*, 61 Wash. 415, 112 P. 495; *La Tourette v. La Tourette*, 15 Ariz. 200, 137 P. 426. The right which the wife has in California, and frequently exercises, to restrain a husband from disposing of or spending any community funds pending the decision of a divorce action effectively protects her when a divorce is in prospect. *California Code of Civil Procedure*, Sec. 526; *Sun Insurance Co. v. White*, 123 Cal. 196; *In re White*, 113 Cal. 282; *White v. Superior Court*, 110 Cal. 54.

Conclusion.

The decision of the District Court is erroneous and should be reversed.

Respectfully submitted,

TODD W. JOHNSON,

In Propria Persona.

No. 10214

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

TODD W. JOHNSON,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

Upon Appeal from the District Court of the United States for the Southern District of California, Central Division.

BRIEF FOR THE UNITED STATES.

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TOPICAL INDEX.

TABLE OF AUTHORITIES CITED.

No. 10214

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

TODD W. JOHNSON,

Appellant,

vs.

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Appellee.

BRIEF FOR THE UNITED STATES.

Opinion Below.

The only previous opinion in this case is that of the District Court [R. 43-50], reported at 45 F. Supp. 377.

Jurisdiction.

This notice of appeal [R. 67-73] involves federal income tax for the tax year 1935, paid by the taxpayer in 1936 [R. 3, 38]. On April 2, 1940, the taxpayer filed a claim for refund with the Commissioner of Internal Revenue. [R. 84.] The claim was rejected by the Commissioner on September 21, 1940. [R. 7, 21-37.] More than six months after filing this claim for refund the taxpayer instituted an action in the District Court for the Southern District of California for recovery of taxes paid. The judgment of

the court denying the claim in part and allowing it in part was entered June 30, 1942. [R. 66-67.] Within three months and on July 13, 1942, the taxpayer filed a notice of appeal in this Court [R. 67-73] pursuant to the provisions of Section 128 (a) of the Judicial Code as amended.

Question Presented.

Whether income received by the taxpayer as his separate property under a settlement agreement preceding divorce is taxable to him in full, under Section 22 (a) of the Revenue Act of 1934, if paid for services rendered prior to execution of the agreement.

Statutes Involved.

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * * * * * *

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) for de-

termining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

* * * * * * * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that— * * *

* * * * * * * * *

Civil Code of California (1937):

SEC. 158. *Husband and wife may make contracts.* Either husband or wife may enter into any engagement or transaction with the other, or with any other person, respecting property, which either might if unmarried; subject, in transactions between themselves, to the general rules which control the actions of persons occupying the confidential relations with each other, as defined by the title on trusts.

SEC. 159. *Contract altering legal relations: Separation agreement.* A husband and wife cannot, by any contract with each other, alter their legal relations, except as to property, and except that they may agree, in writing, to an immediate separation, and may make provision for the support of either of them and of their children during such separation.

SEC. 161a. *Interests in community property.* The respective interests of the husband and wife in community property during continuance of the marriage relation are present, existing and equal interests under the management and control of the husband as is provided in sections 172 and 172a of the Civil Code. This section shall be construed as defining the respective interests and rights of husband and wife in community property.

Statement.

The facts as stipulated by the parties and found by the District Court may be briefly summarized as follows:

The taxpayer was married in 1921 and resided with his wife in California from 1925 until January 1, 1935, when they separated. [R. 51, 78.] While the spouses were domiciled in California and after July 29, 1927, they accumulated considerable property by virtue of the taxpayer's successful legal practice. When they entered into a formal property settlement agreement on March 4, 1935, in anticipation of divorce, this property was valued at $172,379.41. [R. 51-52, 55.] Included was real estate held in joint tenancy, other real and personal property held as community property, and certain accounts receivable for legal service previously rendered by the taxpayer individually and as a 75 per cent partner in a law firm. [R. 52.] Under the property settlement agreement the assets were roughly divided between the spouses. [R. 52.] Under the agreement the taxpayer took as his separate property, among other items, the entire accounts receivable for the legal service he had previously rendered amounting to some $52,028.85. [R. 17, 44, 58.] In turn he transferred to the wife his interest in certain property, assumed the income tax liability of both parties for the tax years 1934 and 1935, and undertook to pay his wife $500 per month for 12 months. [R. 53, 59.] This settlement agreement, the District Court found, did not constitute reciprocal sales of property by or between the spouses. [R. 53-54.]

The taxpayer reports his income on a cash basis. [R. 61, 69.] The fees for previous legal service rendered by the taxpayer were collected by him in the tax year 1935.

[R. 44.] His income tax return reported only one-half of this income and the other half was reported on his divorced wife's returns. [R. 79, 82-83.] The Commissioner assessed a deficiency against him on the ground that this income as his separate property was taxable to him in full [R. 79-83] and in addition disallowed certain deductions claimed as business expenses. [R. 82.] On the Commissioner's determination that an overpayment had been made on account of the taxpayer's former wife it was agreed that the tax paid for her should be credited to the taxpayer's deficiency and he paid the balance. [R. 83-84.] It was further agreed that in the event the taxpayer was successful in his action for a refund that his recovery should be limited to this balance. [R. 85.]

In addition to these findings, as to which there is no dispute, the District Court made the following findings as prepared by the plaintiff[1] and objected to by the Government:

It found that in making the settlement agreement the parties intended to dispose of and transform their property so that each would thereafter own as his or her separate property a half thereof. [R. 52.] The District Court found that prior to this settlement the wife owned an undivided half interest in community accounts receivable worth one-half thereof and a half interest in other joint and community property worth one-half thereof. [R. 54.] The wife's community half interest in the accounts receivable had no cost basis to her but her half interest in

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[1]These findings were prepared by the taxpayer through a procedural accident although he lost on the major issue presented by the case as plaintiff he won on another—a claim for a deduction for business expenses. As the prevailing party he prepared the findings to support the decision in the case. [R. 51-65.]

other joint and community property had a cost to her of half the total cost, or $65,919.75. [R. 57.]

The court further found that under the settlement agreement the wife disposed of and the husband acquired her half interest in community accounts receivable worth $26,014.23 and her half interest in other joint and community property worth $23,175.48. [R. 58.] The husband on the other hand disposed of and the wife acquired his half interest in certain joint and community property worth $37,000. In addition he assumed the wife's income tax liability for 1934 and 1935 amounting to some $8,201.73, making a total of $45,201.73 acquired by her in the settlement. [R. 59.]

The court found as well that the husband's agreement to pay and his payment of $500 per month for one year was in full satisfaction of the rights, if any, which his wife had to receive support, maintenance or alimony from him.[2] [R. 53.]

In his complaint in the District Court the taxpayer sought a recovery of a portion of the tax paid on two grounds. The first was a claim that he was taxable only

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[2]The Government's objection to these findings [R. 131-140] was based on the proposition that the record would not support findings that the wife's community interest in the accounts receivable and other community property was worth one-half thereof, that the cost of her community interest in such property was one-half of the cost thereof, or that the settlement agreement involved a disposition by the wife of a half interest therein and acquisition by the husband of that interest. The finding that the taxpayer's payment of $500 a month for one year constituted full satisfaction of the husband's duty to support the wife was objected to on the ground that the settlement agreement did not permit that conclusion.

The findings were not amended however. [R. 144-145.]

on one-half of the legal fees in question and the second was the assertion of a right to the deductions disallowed by the Commissioner. [R. 2-11.] The decision of the District Court was adverse on the first claim but favorable to the taxpayer as to the claimed deductions. [R. 43-50.]

From that portion of the District Court decision holding him taxable in full on the compensation for service rendered before but collected after the property settlement agreement the taxpayer has appealed. [R. 67-73.]

Summary of Argument.

As a general rule compensation for personal service is taxable to the one who earned it and controlled its disposition. An exception is made in community property states in that the wife's technical ownership of a one-half interest in the husband's earnings makes that portion taxable to her. In California it is competent for the spouses to transmute community property into separate property. This power extends to past earnings as well as future earnings. If past earnings are converted into the husband's separate property before receipt the exception respecting community income is inapplicable to a taxpayer on a cash basis, who thus receives only separate income and his earnings are taxable to him in full under the general rule. That the earnings were converted into separate property before receipt by virtue of a property settlement preceding divorce entitles the husband to no deduction from his income. Expenditures in connection with the dissolution of marriage constitute personal expenditures and as such are not deductible.

Nor can it be said that the property transferred to the wife on such a settlement constitutes a cost of eliminating her interest in his uncollected earnings, entitling the taxpayer to recoup his expenditures before realizing gain. Prior to the settlement the taxpayer had the legal and factual control of his uncollected earnings so he acquired nothing of substance by the settlement. His transfer of property to the wife was incident to the dissolution of the marriage, not as the cost of anything to be acquired in a capital transaction. The spouses were free under California law to divide the property as they wished. The taxpayer could have transferred to his estranged wife property worth several times his uncollected earnings—it surely would not be argued in such a case that a capital loss could thereby be sustained. The reason why no such loss would be recognized in such a case and the reason why no cost basis for any portion of the taxpayer's earnings can be here recognized is the fact that the property transfer was a part of a marriage settlement rather than a capital transaction. Since his earnings collected by the taxpayer in 1935 were received by him as a separate property they were taxable to him in full. No portion of such earnings was taxable to the wife for she had never enjoyed legal or factual control thereof. Nor did she have any technical ownership of them when received.

Argument.

I.

Under the Law of California the Taxpayer's Earnings Were His Separate Property by Virtue of the Property Settlement and Were Therefore Taxable to Him in Full.

The taxpayer attacks the decision of the District Court holding him taxable in full on fees for service rendered prior to the spouses' property settlement but collected thereafter. In essence he seeks the benefit of the community property system for income received as his separate property after he had formally chosen to abandon the system. The decisions of the Supreme Court and this Court will not permit this.

In *Van Every v. Commissioner,* 108 F. (2d) 650; *Boland v. Commissioner,* 118 F. (2d) 622; *Van Dyke v. Commissioner,* 120 F. (2d) 945; and *Somerville v. Commissioner,* 123 F. (2d) 975, this Court held that earnings received by the husband as his separate property, under a settlement agreement preceding divorce or separation, are taxable to him in full. Those cases are decisive here, as can be shortly demonstrated.

For taxpayers reporting income on the basis of cash receipts the federal income tax on compensation for personal service is assessed, under the general rule, against the person who earned it and controlled its disposition. *Lucas v. Earl,* 281 U. S. 111; *Helvering v. Eubank,* 311 U. S. 122. In the case of earnings in the community property states, an exception to the general rule has been established. The local law vesting in the wife a technical one-half interest in the husband's earnings has been recognized for federal income tax purposes so that half

of the community income is taxable to her when paid as such. This privilege of dividing the husband's earnings between the spouses for federal income tax purposes extends only to that income which the local law classifies as community property in which the wife has a vested interest.

United States v. Robbins, 269 U. S. 315.

Under California law the spouses can convert community property into the separate property of one of them. California Civil Code, Sections 158, 159, *supra.* The California cases so holding are collected in an annotation in 120 A. L. R. 264, 265. This power to convert community property into the separate property of the husband extends to compensation earned but not paid as well as to future earnings, contrary to the implication in the taxpayer's brief (pp. 14-17). As this Court stated in *Boland v. Commissioner,* 118 F. (2d) 622, 624:

> Under the law of California (Civil Code Calif., §§158, 159), recognized by this Court (*Van Every v. Commissioner,* 9 Cir., 108 F. 2d 650; *Helvering v. Hickman,* 9 Cir., 70 F. 2d 985; *cf. Black v. Commissioner,* 9 Cir., 114 F. 2d 355, 358), a husband and wife, living in California, may enter into an agreement with each other altering their legal relations as to property and change the character of property from community to separate property, or from separate to community, *theretofore acquired, or thereafter to be acquired.* [Citing several California decisions.] (Italics supplied.)

See also:

> *Kaltschmidt v. Weber,* 145 Cal. 596, 79 Pac. 272;
>
> *Wren v. Wren,* 100 Cal. 276, 34 Pac. 775.

The effectiveness of the spouses' agreement to convert what would otherwise be community income into separate income was recognized for income tax purposes by this Court in *Van Every v. Commissioner, supra; Boland v. Commissioner, supra;* and *Somerville v. Commissioner, supra.* The fears expressed by the taxpayer at the tax evasion engendered by recognition of power to "retrospectively" convert compensation already earned but not paid into separate income (Br. 16) apply as well to the admitted power in the spouses to alter prospectively the character of compensation neither earned nor paid. If the local law governs as to one it certainly does so as to the other.

As a matter of fact this power, by settlement agreements, to shift the incidence of federal income taxation from one spouse to the other is limited. A taxpayer on a cash basis may not shift the tax to his wife where his compensation has been earned and paid prior to the settlement agreement, for the reason that the tax status of such earnings was fixed on their receipt as community property. *Van Dyke v. Commissioner,* 120 F. (2d) 945, 946 (C. C. A. 9th). But where the agreement precedes the happening of the taxable event (receipt of the income for a taxpayer reporting on a cash basis) the settlement agreement making uncollected income the separate property of one of the spouses does shift the tax burden. *Cf. Poe v. Seaborn,* 282 U. S. 101; *Anderson v. Commissioner,* 78 F. (2d) 635, 639 (C. C. A. 9th). That is the situation in the instant case where the settlement agreement preceded the collection of the earnings in question.

The property settlement agreement executed by the taxpayer and his wife provided that he "shall have as his sole and separate property the following personal property,

the title to which stands in his name: * * * His interest in the partnership of Johnson & Johnston, attorneys-at-law; * * * Any fees outstanding for services performed by [him] * * *." [R. 17.] It is clear in light of the foregoing authority that the taxpayer received the compensation in question as his separate property and that his wife had no interest therein. Since he reports his income on a cash basis it follows that, on the happening of the taxable event, his receipt of those earnings, they were includible in full in his gross income for that tax year.

The taxpayer's contention that he is taxable only on one-half of this separate income is thus seen as an attempt to secure a deduction for the property transferred to his wife by the settlement agreement preceding divorce. It is well settled, however, that no deduction can be had for expenditures incurred in connection with dissolution of marriage. Such expenditures are regarded as personal and Congress, for the tax year here involved, made no provision for their deduction from gross income so none can be had.[3] *Gould v. Gould,* 245 U. S. 151; *Ullman v. Commissioner,* 6 B. T. A. 100, 102. This principle is implicit in the decisions of this Court in *Van Every v. Commissioner,* 108 F. (2d) 650; *Boland v. Commissioner,* 118 F. 2d 622, and *Somerville v. Commissioner,* 123 F. (2d) 975. In these cases taxpayers were taxed in full on their separate income without regard to the property transferred to the wife in the settlement agreement preceding separation or divorce which gave their income that status as separate property.

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[3]In the Revenue Act of 1942, Public Law 753, 77th Cong., 2d Sess., Section 120, Congress has changed the law prospectively in some respects by providing that alimony and alimony trust income shall be taxable to the divorced wife and excluded from the husband's gross income.

II.

No Income Tax Can be Levied Against the Wife Whose Community Property Interest in the Husband's Earnings Is Surrendered to Him Prior to His Receipt Thereof.

The taxpayer advances several ingenious arguments designed to by-pass the fundamental principle that payments for settlement of financial obligations incident to marriage are not deductible from gross income. Consideration may first be directed to his assertion that the accrual of the right to income is the taxable event for a taxpayer reporting on a cash basis and that since the earnings in question accrued as community income they must be taxed as such. This assertion ignores the fact that compensation has no status until the moment of the receipt and amounts to an attack on the fundamental and well established distinction between reporting income on an accrual as compared with a cash basis. If the cash basis is used, as it was here, it is the receipt, not the accrual of right to receive, that is the taxable event. *Sivley v. Commissioner,* 75 F. (2d) 916 (C. C. A. 9th). Regulations 94, Article 42-1,[4] issued under the Revenue Act of 1936, so provides as do all its earlier and later counterparts.

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[4]Art. 42-1. *When included in gross income.*—Except as otherwise provided in section 42 in the case of the death of a taxpayer, gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included as of a different period in accordance with the approved method of accounting followed by him. (See articles 41-1 to 41-3.) * * * If no determination of compensation is had until the completion of the services, the amount received is ordinarily income for the taxable year of its determination, if the return is rendered on the accrual basis; or, for the taxable year in which received, if the return is rendered on the receipts and disbursements basis. If a person sues in one year on a pecuniary claim or for property, and money or property is recovered on a judgment therefor in a later year, income is realized in the later year, assuming that the money or property would have been income in the earlier year if then received. * * *

The decisions cited by the taxpayer actually serve to demonstrate that it is the receipt that is the taxable event for a cash-basis taxpayer. *Helvering v. Enright,* 312 U. S. 636, applied the accrual test to income uncollected by a decedent at his death because Section 42 of the Revenue Acts of 1934 and subsequent years expressly authorizes this deviation from the fundamental basis for computing income to a cash-basis taxpayer. If any doubt existed whether accrual of the right or actual receipt is the taxable event for a cash-basis taxpayer this provision adopting the former as to decedents is persuasive that in other cases it is the receipt which is the taxable event. The decisions in *Helvering v. Horst,* 311 U. S. 112; *Helvering v. Eubank,* 311 U. S. 122; and *Harrison v. Schaffner,* 312 U. S. 579, all involve assessments for the period in which the income was paid. Hence they affirmatively support the principle that receipt is the taxable event. These decisions are noteworthy because they make it clear that a taxpayer who has become entitled to receive income, by labor or investment, may receive it for tax purposes on its payment to another at his direction, even by way of gift. Underlying these decisions is the assumption that the taxpayer, by virtue of his labor or investment, has (1) experienced an economic gain and (2) acquired an untrammeled right to receive and (3) to control the disposition of this gain. As stated in *Harrison v. Schaffner, supra* (pp. 581, 582):

> * * * one who is entitled to receive, at a future date, interest or compensation for services and who

> makes a gift of it by an anticipatory assignment, realizes taxable income quite as much as if he had collected the income and paid it over to the object of his bounty. *Helvering v. Horst,* 311 U. S. 112; *Helvering v. Eubank,* 311 U. S. 122. Decision in these cases was rested on the principle that the power to dispose of income is the equivalent of ownership of it and that the exercise of the power to procure its payment to another, whether to pay a debt or to make a gift, is within the reach of the statute taxing income "derived from any source whatever."
>
> * * * * * * * * * * * * by the exercise of his power to command the income, he (the taxpayer) enjoys the benefit of the income on which the tax is laid.

The taxpayer's attempt by reference to these decisions to establish that his former wife received one-half the income in question indicates a basic failure to appreciate the principle on which they rest. He argues that under California law accounts receivable for service previously rendered by the husband were community property, that the wife thus owned a half interest therein and that her transfer thereof to the husband in the property settlement should be treated just as the assignment of earnings in the *Eubank* case, *supra,* so as to render her taxable thereon. Assuming *arguendo* that the accounts receivable for service rendered by the husband acquired a status as community property, the question may be asked whether the wife had (1) thereby experienced economic gain (2) whether she had a right to receive the earnings, and (3) whether she had a right to freely dispose of the same.

Without embarking on an exhaustive catalogue of the attributes of California community property and all statutes and decisions relevant thereto it may be observed that the husband's earnings are subject to his exclusive management and control even when received as community property. California Civil Code, Section 172: *Hannah v. Swift,* 61 F. (2d) 307, 310 (C. C. A. 9th); *Grolemund v. Cafferata,* 17 Cal. (2d) 679, 111 Pac. (2d) 641. The wife has no power to dispose of her interest in his community earnings save by relinquishing it to her husband. California Civil Code, Sections 159, 167. He can spend these earnings for current expenses or for any other purpose without accountability then or later to the wife. California Civil Code, Section 172. Prior to and after his death these earnings are subject to claims against him in his individual capacity (*Grolemund v. Cafferata, supra;* California Probate Code, Section 202); and his earnings as community property are not subject to claims of his wife's creditors (*Grace v. Carpenter,* 42 Cal. App. (2d) 301, 108 Pac. (2d) 701). Suits respecting collection and expenditure of these earnings can be instituted by the husband and in his name alone.

> *Johnson v. National Surety Co.,* 118 Cal. App. 227, 5 Pac. (2d) 39, 40.

The wife's only rights respecting the husband's community earnings are (1) protection against their dissipation by gift (but she has no protection against foolish expenditure) (California Civil Code, Section 172), and (2) the right to a half portion on dissolution of the marriage by the husband's death or otherwise while she is still living if anything representing these earnings remains after payment of his debts and the expenses of administration (California Probate Code, Section 201).

Thus it is seen that the wife's interest in California community property prior to dissolution of the marriage is a very technical one,[5] even though characterized as a vested interest. It is clear therefore that acquisition by the husband of accounts receivable for service rendered by him gave rise to no direct economic gain to the wife. She had then no right to receive these earnings or any part thereof and she most certainly had then no right to freely dispose of the same. All of the three prerequisites to application of the *Horst, Eubank* and *Schaffner* cases, *supra,* are therefore absent.

The taxpayer's contention that a settlement agreement is the equivalent of the assignment in the *Eubank* case, *supra,* is also opposed to this Court's decisions in *Van Every v. Commissioner, supra; Boland v. Commissioner, supra; Somerville v. Commissioner, supra;* and *Van Dyke v. Commissioner, supra.* Those cases involved the tax effect of settlements on future earnings. Assignments of future earnings, however, are just as ineffective to shift the incidence of federal income taxation as assignments of past earnings. *Lucas v. Earl,* 281 U. S. 111. This Court correctly held settlement agreements effective

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[5]In *United States v. Goodyear,* 99 F. (2d) 523, 527, this Court stated with respect to community property that:

> We think that theoretically each spouse had possession and enjoyment of his particular interest.

This "possession and enjoyment," vested in the wife on the happening of the taxable event for estate tax purposes (the death of the husband), was held sufficient to prevent inclusion of one-half the community property in his taxable estate. It is noteworthy that the wife there retained her community interest on the happening of the taxable event. It is significant as well that this Court characterized the wife's enjoyment and control of her community interest as "theoretical."

Recognizing the theoretical nature of the wife's community interest, Congress, in Section 402 of the Revenue Act of 1942, Public Law 753, 77th Cong., 2d Sess., provided for inclusion in the decedent's estate of property held with the spouse as community property, except that portion thereof actually contributed by the surviving spouse.

to shift the tax burden because the wife's relinquishment of her community interest in the husband's earnings does not represent the exercise of command over earnings represented when one assigns his earnings, past or future.

The taxpayer's reliance on *Poe v. Seaborn,* 282 U. S. 101, and *United States v. Malcolm,* 282 U. S. 792, for the proposition that prior to receipt of these earnings the wife had control thereof is misplaced, for these cases involved income received as community property and they hold merely that the wife's community interest in such income is a sufficient basis for taxing one-half of it to her. These decisions are unique in recognizing legal title to income as a basis for assessment of the federal income tax. More recent decisions of the Supreme Court, particularly the *Horst, Eubank* and *Schaffner* cases, *supra,* and *Helvering v. Clifford,* 309 U. S. 331, emphasize possession of the "normal concept of full ownership",[6] *i. e.,* the right to enjoyment and control of the disposition of income as the basis for identifying the income recipient for tax purposes. The extension of the *Seaborn* and *Malcolm* cases to a situation where the income involved was never received as community property is certainly not warranted by these later Supreme Court decisions. As a matter of fact they clearly indicate the contrary. The husband here earned the income in question, was entitled before the property settlement as well as after to receive it and to freely spend the same. It was paid, after the settlement, as his separate property, so he must therefore be taxed in full thereon.

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[6]This shorthand analysis of the rationale of these decisions is taken from *Bateman v. Commissioner,* 127 F. (2d) 266 (C. C. A. 1st).

III.

No Deduction Can be Had for Property Transferred to the Wife Prior to the Divorce Pursuant to Property Settlement.

As an auxiliary argument to the one just considered the taxpayer contends that he is entitled to subtract from the earnings in question the value of certain property transferred to his wife by the property settlement.

This property transferred, he contends, represents the cost of the earnings. This can only be so if the property was transferred as the purchase price of the wife's interest in his uncollected earnings, *i. e.,* that the settlement agreement was a sale. It is on the theory that it did constitute a sale and on that theory alone that the taxpayer rests his argument for a cost basis for the earnings in question. (Br. 21, 44.)

In direct opposition to this construction of the facts the District Court found that the settlement agreement did not constitute a "sale". [R. 53-54.] Moreover to allow the taxpayer a cost basis for any portion of his earnings would permit the conversion of taxable income to capital without assessment of an income tax. Earnings must be taxed as income before they attain the status of capital. *Bull v. United States,* 295 U. S. 247, 256, 257.

Congress most certainly did not intend that any portion of earnings from personal service should not be taxable as such. Acceptance of the taxpayer's contention that a half of his earnings were received by him as a result of a sale, however, would mean that this half would never be taxed as earnings since the wife, as seen above, is not taxable on the basis of receipt of any of his earnings. This indefensible position results from failure to properly

distinguish between capital transactions and personal expenditures.

In order to receive and enjoy his earnings a taxpayer is called on to make many expenditures that are regarded, not as the cost of securing the earnings, but rather as non-deductible personal expenses. Thus expenditures for food, clothing and shelter, while essential to receipt and enjoyment of earnings are not regarded as capital transactions but as personal expenditures. Money expended for support of the family is likewise non-deductible. In this category as well fall expenditures made in connection with divorce.

In both the community property and non-community property states the husband is under a duty to support the wife and his earnings are subject to this obligation. See Vernier, American Family Laws, Vol. III, Sec. 161. If, in a non-community property state, the husband in anticipation of divorce transfers property to his wife, that transfer gives him no basis for a deduction for federal tax income purposes. This is so even though in one sense the property transferred represents the cost of securing freedom from the obligation to support the wife, enabling his full enjoyment of his earnings. Since expenditures in support of the wife are not deductible the taxpayer cannot improve his tax position by merely making such payments in advance in the form of a property settlement. See cases cited in Point I. The true nature of such a transaction is thus a settlement of the marital obligation of support rather than a capital transaction. Is there any basis for treating such a settlement in California differently for federal income tax purposes? The taxpayer argues that there is.

In his brief he contends that "prior to the property settlement, he was never the owner of more than his half of such earnings, which he owned as a member of the marital community" (p. 42), that in order to secure his wife's one-half interest he tranferred certain property to her and hence he should be entitled to deduct the value of the property transferred as the cost of the interest secured from his wife and be taxed only to the extent of the gain thereon.

Basically this argument is simply another aspect of that considered in the preceding point. The fallacy in it is the same—a misconception of the realities of the transaction. As a matter of fact the argument for a cost-basis deduction from the earnings in question is opposed to the decisions of this Court in *Van Every v. Commissioner,* 108 F. (2d) 650; *Boland v. Commissioner,* 118 F. (2d) 622; and *Somerville v. Commissioner,* 123 F. (2d) 975. This last cited case is typical. There the taxpayer entered into a property settlement with his wife in anticipation of divorce wherein it was agreed that the husband should pay his wife half of his earnings for the next two years. Notwithstanding the fact that he paid one-half thereof to the wife, this Court held that he was taxable on his entire earnings for those years.

The taxpayer has attempted to distinguish these decisions on the ground that they involved income earned after the property settlement. (Br. 14.) As previously noted, however, the effectiveness of such agreements to convert community property into separate property operates equally as well on past earnings as on future earnings. The fact that the agreement here operated on past earnings not received while the one involved in

the *Somerville* case operated on future earnings not received is a distinction without significance. If the wife's interest in the community were that of a commercial partner, as the taxpayer seems to contend (Br. 13, 19, 25), her right to a half of all future earnings of the husband would certainly be a valuable property right. Hence it could be plausibly contended that the payments made to the wife in the *Somerville* case represented the *cost* of acquiring that property from the wife so that the husband should be entitled to deduct it as the *cost* of securing his earnings as separate property. Despite the superficial plausibility of this line of argument the fact remains that this Court squarely held in that case that the husband was taxable in full on the earnings that he received as his separate property. So here also the taxpayer is entitled to no deduction on account of the property transferred to the wife, for the reason that such expenditure does not represent the cost of anything acquired from the wife.

The basis and the only basis on which the taxpayer asserts the applicability of Sections 111 and 113 of the Revenue Act of 1934, governing capital transactions, is the theory that "In effect appellant [taxpayer] purchased his wife's one-half interest in said fee accounts receivable". (Br. 21, 44.) That is the starting point of his argument for a cost basis for the portion of the earnings in question and the point at which the argument collapses.

In *Commissioner v. Larson,* decided October 21, 1942 (1942 Prentice Hall, par. 62,998), this Court very recently held that after dissolution of the community by the husband's death the taxability of income received during the administration of his estate was to be determined

by reference to the substance of the situation, *i. e.,* who received and controlled such income. There the estate was held taxable in full on the income so received notwithstanding the wife's community interest therein. So here with respect to income received after dissolution of the community must regard be had for the substance of the situation in determining the tax liability.

As seen hereinbefore the husband was entitled prior to the property settlement to enjoy all the *substantial* attributes of ownership to his entire earnings including the right to spend them as he chose. It is perfectly clear that the taxpayer did not transfer any property to the wife as the cost of purchasing any technical property interest she had in his community earnings prior to their receipt and prior to the settlement. Such property rights could not have been purchased from the wife by a third party and would have been of no value to the husband, for without them he could spend these earnings as he pleased. The findings of the District Court that the value of the wife's interest in the community property was one-half thereof [R. 54] and that the cost to her of her interest in the community property was one-half the cost thereof [R. 57] were prepared by the taxpayer through a procedural accident [R. 51] and objected to by the prevailing party. [R. 131-143.] To the extent that they suggest that a wife's community interest in her husband's earnings is to be valued as a commercial partner's 50 per cent interest these findings are misleading. Since they are unsupported by the evidence in the record [see R. 102-105, 133-134] and opposed to the actual decision in the case they are entitled to no weight.

The realities of the situation are that apart from the impending divorce the wife's property in the husband's community earnings not yet received was a technical interest only, of no value to him. He transferred valuable property to her under the settlement agreement, not as the purchase price or the cost of this technical present interest she had in his community earnings, but as the satisfaction of the claim she would have had on the dissolution of the marriage by divorce. Just as the law in non-community property jurisdictions variously provides for a claim by the wife against the husband on dissolution of marriage so in California the wife on divorce for the husband's fault has a claim for one-half the community property (California Civil Code, Section 146) and in addition to an allowance for her future support if warranted by the parties' circumstances (California Civil Code, Sections 139, 142). Therefore in the property settlement agreement the taxpayer did not transfer property as the purchase price for something he did not then possess but rather as the price of settling claims which the wife could assert only in connection with the dissolution of the marriage.

This is made clear by the provision in the settlement agreement that the property transferred by the husband should be "* * * in lieu of all other compensation or claims of any kind * * *" the wife had against him. [R. 19.] These included her claim to one-half the community property on dissolution of the marriage, her claim to support, maintenance or alimony for the rest of her life, her claim to administration of his estate, to a probate homestead, to a family allowance and to inheritance in case he should predecease her in marriage. [R. 136-137.] If, as the taxpayer contends, the property settlement was

a sale then all these claims would have to be valued in order to ascertain the portion of his cost allocable to the earnings in question. The failure of the taxpayer to introduce evidence respecting the value of these claims means that he has failed to establish the cost basis for the earnings in question, thus requiring the conclusion that he realized by the settlement agreement income in at least the amount determined by the Commissioner. This argument was developed in the defendant's motion for additional findings in the District Court. [R. 136.]

If the case is not to be resolved against the taxpayer on this basis it is because, contrary to his contention, the settlement agreement was not a sale. The District Court found that it was not a sale. [R. 53-54.] Actually, in that agreement the taxpayer purchased, not capital items, but freedom from marriage-related claims of the wife. In other words, the settlement was like one in any other state—the price of divorce. Whether that price be described as alimony or as a property settlement is immaterial. To the wife an award received by virtue of the divorce or a voluntary settlement preceding divorce substitutes for the husband's support. To the husband the substance of the transaction is an expenditure to free his earnings from the wife's claim to support. Hence the expenditure as an incident to the dissolution of marriage is a personal one to the husband and as such is not deductible. To argue that the property transferred by the taxpayer was the price paid for a portion of his uncollected earnings is to disregard the fact that prior to the settlement agreement he had the right to collect these accounts receivable and spend the proceeds for anything he wished. The only thing of value the wife had relat-

ing to these earnings was a claim in connection with the approaching divorce.

It must be recognized that the property transferred by the husband was the cost of dissolution of the marriage which resulted in simply freeing his earnings from a prospective claim by the wife, not in the acquisition of a capital item having a cost basis. Hence it is clear that a capital transaction was not involved so the case does not fall under Sections 111 and 113 of the Revenue Act of 1934. As stated by the Board of Tax Appeals in a similar case, *Crosby v. Commissioner,* 46 B. T. A. 323, 331:

> The right received by the petitioner [taxpayer] was one to receive ordinary earnings, and not property acquired through capital expenditure.

The collection by the taxpayer of his previous earnings did not involve the sale or other disposition by the taxpayer of any property for which he had a cost basis. He simply collected his earnings as such and they are taxable to him in full as his separate property.

The soundness of the above analysis can be demonstrated by considering what the taxpayer's position would be if, in the property settlement, he had transferred to his wife all the community property save the accounts receivable. Such a transfer might result if the wife drove a hard bargain. Could it be argued that the taxpayer's uncollected earnings had a cost basis equal to the property transferred so that a deductible loss would have been realized on their collection? Clearly the property transferred could not be so treated for it would represent, not the cost of the earnings, but the cost of dissolution of the marriage.

It may be observed that since the wife's community property interest in his earnings has no cost basis in the husband's hands and since he has never received anything by reason of his possession of this interest no question arises as to whether there has been a sale or other disposition thereof either by virtue of the settlement agreement or collection of the accounts receivable. The case of *Commissioner v. Mesta,* 123 F. (2d) 986 (C. C. A. 3d), relied on by the taxpayer (Br. 31, 35-38) is in no way inconsistent with this conclusion. There it was held the husband's transfer of stock to his wife under a settlement agreement preceding divorce constituted a "disposition" of that property within the meaning of Section 111(a) of the Revenue Act of 1934, rendering him taxable on the difference between the market value at the time of transfer and the cost. It is not suggested by the opinion in that case that the transfer gave the taxpayer a cost basis for the stock The stocks conceded cost basis was the sum the taxpayer had paid for it on its sale to him prior to the transfer of this stock to his wife under the settlement agreement. In the instant case it is admitted that prior to the settlement agreement there was no cost basis for the earnings. Hence the *Mesta* case is inapposite. In fact its characterization of a transfer of property under a settlement agreement as a "disposition" rather than a "sale" is opposed to the sale theory on which the taxpayer sought to establish a cost basis for the earnings in question.

Inasmuch as the husband transferred property in a settlement preceding divorce rather than as a part of a capital transaction he has no cost basis for the earnings in question and they are taxable to him in full.

Conclusion.

The decision of the District Court was correct and should therefore be affirmed.

Respectfully submitted,

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